Our work in regulating the Scottish water industry:

Background to and framework for the Strategic Review of Charges 2006-10

volume **2**

WATER INDUSTRY
COMMISSIONER
FOR SCOTLAND

Contents

Foreword

My role is to promote the interests of customers. In my first full Strategic Review of Charges in 2001 I outlined a number of challenges that faced the water industry in Scotland. Meeting these challenges required difficult decisions.

The creation of Scottish Water has brought benefits to customers throughout Scotland. Customers in all parts of Scotland are now paying less than they would have paid if Scottish Water had not been established. Years of worsening efficiency in the Scottish water industry have been halted, and the rate at which efficiencies are being made is beginning to improve significantly.

In 2001, I said that if the industry meets the challenges it faced, then by 2006 customers could expect that their bills would not have to increase in real terms in order for them to enjoy an environmentally and financially sustainable service. Scottish Water has made a good start in meeting the challenges that I set in my Strategic Review. I am therefore optimistic about the prospects for tariffs, although it is still too early to say what individual customers may have to pay. This will become clearer after the Minister provides me with guidance on investment priorities and the principles of charging. This guidance will reflect the response to the Scottish Executive's two consultations: '*Paying for water services 2006-10*' and '*Investing in water services 2006-10*'.

Notwithstanding its progress to date, Scottish Water has more to do if it is to meet the service and cost levels of the industry in England and Wales. I therefore intend to set further operating and capital efficiency targets for Scottish Water. These will be challenging but achievable and could further limit the prices faced by customers. Customers will expect to see similar progress in the level of customer service.

I will shortly be publishing a detailed description of the methodology that I propose to adopt for the *Strategic Review of Charges 2006-10*. This methodology will explain the factors that I will take into account in determining efficiency targets, investment levels and customer service standards for the next regulatory period. I will be particularly interested in whether stakeholders believe that we should set targets for improvements in customer service. I would also welcome comments from stakeholders both about those elements of the methodology where I propose to use current regulatory best practice and those areas where there are a number of potential approaches.

This is the second publication about our work in regulating the Scottish water industry. It covers the background to and the framework for the *Strategic Review of Charges 2006-10*. It is important to understand the background to the last Review, in order to clarify both the changes to the process that we are introducing and the initiatives to strengthen the regulatory framework that are proposed by Scottish Ministers.

I welcome the Minister's proposals that the current regulatory regime should be strengthened. These proposals are consistent with normal regulatory practice in other utilities and in the water industry south of the border. In particular, I believe that the introduction of a Commission will help to depersonalise regulation. I also believe that giving the Commission the power to decide, rather than to advise, on prices should improve the transparency of the role of regulation. The proposed rights of appeal that will be available for Scottish Water should also improve transparency.

A strengthened regulatory regime brings increased responsibility. Scottish Ministers have asked me to prepare this second full Strategic Review of Charges on the basis that the final outcome could be the first determination of prices for the water industry in Scotland by the new Water Industry Commission for Scotland. In order to ensure that the outcome is consistent with regulatory best practice, I will prepare this Review according to the Better Regulation Task Force Principles of accountability, transparency, proportionality, consistency and targeting. As such I intend to publish the key information submissions that I receive from Scottish Water, as well as the tools that I will use to complete my analysis, including my financial and tariff basket models.

I am keen to facilitate debate about the challenges that still face the water industry in Scotland. My office has planned a number of stakeholder information days over the next 18 months. I encourage stakeholders to come and to express their views. These views will help to inform the Strategic Review of Charges.

Alan D A Sutherland
Water Industry Commissioner for Scotland
August 2004

Executive summary

Introduction

The principal statutory duty of the Water Industry Commissioner for Scotland (WICS) is to promote the interests of customers. We promote the interests of customers primarily by encouraging Scottish Water to become more efficient. Cost cutting is not efficiency. Efficiency is about reducing costs and maintaining or improving the levels of service to customers. Scottish Water can therefore become more efficient by reducing its cost to deliver an acceptable level of service or by improving its service to customers without increasing its costs.

The last Strategic Review of Charges covered the period 2002-06. In November 2005 we shall publish our second full Strategic Review of the Scottish water industry. The Review will outline the price and revenue implications for customers of Scottish Water for the period 2006-10.

This is the second of a series of five information and consultation documents which we are publishing between July and September this year, and which will set out our proposed methodology and approach for the Review. All of the documents that we have published, and will publish over the coming months concerning the Review, reflect our intention to provide an open and transparent process. This is in accordance with our commitment to the Better Regulation Task Force principles of proportionality, accountability, consistency, transparency, and targeting[1].

In this document we outline the background to our work in assessing the appropriate level of prices. It divides into two parts;

Section 1 sets out and explains the background of the Review and the current regulatory framework; and

Section 2 discusses the changes to the regulatory framework that are anticipated in the near future and the impacts that these changes might have both for regulation and for customers.

We are also planning to hold a series of workshops and stakeholder information days where interested parties may express their views in person. Details of these events were contained in *Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges*, which was published in July 2004 and is available on our website.

Economic regulation

Prior to setting out the framework for the next Strategic Review of Charges, it is important to explain the role of regulation within the water industry in Scotland.

The purpose of regulation is to seek to ensure that monopoly businesses act in the customer interest. Customers should not have to pay higher prices or accept lower levels of service because they are unable to choose their supplier.

Network utility industries tend to be monopolies because the cost of replicating the network is excessive. Economists describe them as involving a significant ‘natural monopoly’ element. A ‘natural monopoly’ refers to the situation where there is only one firm supplying a product in the market, but this is not the result of the behaviour of the firm. Instead, it arises because it is the sensible way to organise the industry and it is in the best interests of customers.

However, the behaviour even of natural monopolies may work against the customer interest if unchecked. There are two ways in which this might happen.

First, if the service is essential and the customer has no choice about where to purchase it, the monopoly has an incentive to charge an excessive price and to make excessive profits.

Second, in the absence of competition the monopoly faces no incentive to innovate and improve its efficiency over time.

Economic regulators[2] seek to establish a tight budgetary constraint on the regulated body. In other words, clear

[1] The Better Regulation Task Force was established in September 1997. It is an independent body that advises Government on action to ensure that regulation and its enforcement accord with the five Principles of Good Regulation. For further information see http://www.brtf.gov.uk.
[2] Regulation of a public sector corporation is not unique. Postcom fulfils a similar role to WICS in its regulation of the Royal Mail. The Civil Aviation Authority (CAA) also has economic regulation responsibilities for the locally owned Manchester Airport.

statements are made about the outcomes for customers that the body must deliver and about the amount of money that can be spent. This can be achieved by fixing the maximum return available (unless targets are beaten) or by limiting the total cash funds that may be consumed.

The tight budgetary constraint should focus the attention of management on delivering ongoing improvements in value for money to customers. This explains why regulators publish regular assessments of the financial performance of the companies or organisations they regulate.

In a competitive market, companies face similar tight budgetary constraints in that they have to match their costs to the revenue they can win from customers. Regulation consequently provides a proxy for the discipline of competition.

The creation of Scottish Water

The *Strategic Review of Charges 2006-10*, unlike its predecessor, will focus solely on the activities of Scottish Water. In the last Strategic Review of Charges (2002-06), the creation of Scottish Water from the three previous water authorities was still subject to ministerial approval.

The three separate authorities remained in existence until the formation of Scottish Water under the Water Industry (Scotland) Act 2002 on 1 April 2002. Under sections 21-23 of the Act the functions, property, liabilities, and staff of the water and sewerage authorities were transferred to Scottish Water.

Scottish Water remains in the public sector, and is owned by and accountable to the Scottish Executive and Ministers. However, the structure and management of Scottish Water draws on the private company model. The combination of public sector ownership and private sector organisational structure is intended to ensure that the business is run in the public interest as efficiently as possible.

Scottish Water has completed two years in its new form and has made good progress in reducing its operating costs. To date, progress in the delivery of the capital programme is less encouraging. Customer benefits will only fully be realised when progress in improving the efficiency and delivery of the capital programme accelerates.

If a public sector organisation can match the level of efficiency of investment and service delivery that is achieved by the private sector, customers of that public sector supplier could expect sustainably lower prices than could ever be achieved by the private sector. This is because the public sector is consistently able to access a lower cost of capital. There can be no doubt that customers of Scottish Water benefit significantly from access to attractive terms for public government loans that are much cheaper than the private sector's cost of capital[3].

It is important to note that this cost benefit will only truly be realised by customers if they are not exposed to operational risks and if the service is delivered efficiently. However, as regulator we must take into account that customers of Scottish Water are more immediately exposed than customers in England and Wales to the financial risks of the business. This is because there are no private equity shareholders.

The Strategic Review of Charges 2002-06

Our analysis showed that a sustainable water industry in the public sector would require action to be taken in the following areas:

- increased revenue to the minimum level consistent with meeting ongoing maintenance and environmental/public health compliance;
- challenging but achievable efficiency targets;
- further improvement in customer service;
- harmonised and broadly cost-reflective tariffs;

[3] We estimate that customers of Scottish Water probably benefit by around £44 million per year, because of a 2% saving on the annual cost of capital (about 4.5% on the average bill). We have calculated this on the basis of current total borrowing of approximately £2.2 billion.

- improved regulation and financial control;
- improved performance monitoring; and
- better governance.

The level of revenue

We showed that the Scottish industry had spent considerably more, in the past several years, than it received in customer charges. We explained that this was a problem because there was a likelihood that sustained investment at current levels will be required for the foreseeable future.

Continuing to increase net borrowing significantly to eliminate the gap between revenue and expenditure will only make matters worse. Borrowing may delay a price increase, but it will increase future bills by the interest payable on any additional borrowing. In providing our advice on the level of revenue, we took into account a clear customer concern that the industry had “to get its house in order” and that, as a commodity business, “it should learn to live sustainably without real increases in price”. We believe that the revenue increases that were implemented will ensure that we have a more sustainable industry in the future and that customers will see the benefits in steady prices. If Scottish Water continues to make progress in reducing its costs, it is possible that prices will not need to increase in real terms.

Challenging but achievable efficiency targets

The charges paid by customers in the public sector model are a direct function of the efficiency of the water industry in Scotland. Unlike in the private sector, there are no dividends for shareholders from any profit. Any surplus in Scotland can go wholly to financing investment and improving the service to customers. There are no trade-offs between the customer and the shareholder.

We set three separate efficiency targets to cover operating costs, capital expenditure, and the potential savings resulting from the merger of the three authorities. These efficiency targets were challenging but achievable. After two years, we can see real progress in reducing operating costs. Scottish Water is also confident that the creation of Scottish Water Solutions will improve both the timeliness and the efficiency of the delivery of capital investment.

The total annual value to customers if Scottish Water achieves the efficiency targets is in excess of £400 million a year by the end of the current regulatory period in 2005-06. Such an achievement would result in customers’ bills being some 40% lower than would otherwise have been the case[4]. These efficiencies are important because a sustainable water industry needs to be affordable both now and in the future.

Harmonised and broadly cost-reflective tariffs

When the Minister for the Environment, Sport and Culture, Sam Galbraith, MSP announced his intention to merge the three water authorities, he highlighted the harmonisation of charges as an important benefit. There were clearly significant anomalies in the charges that resulted from the three-authority model. It is, for example, much cheaper to supply Dundee than North Fife, yet charges were much higher in Dundee. It was more expensive to serve south Ayrshire than the western Central Belt, yet charges would be the same. We considered that a harmonised charge across Scotland was equitable for all customers. To do otherwise would have been to sanction a postcode lottery in charges for water. It would also break with normal practice in the pricing of utility services – ie to harmonise prices across the whole of a company’s area.

There has been some comment about our recommendation that charges for businesses should also be harmonised across Scotland. There were three reasons why we considered that this was important.

- The merger of the three authorities only made sense if cost savings, investment prioritisation and a single management structure were to be introduced. This would remove the justification for differential

[4] This takes no account of any rebalancing between revenue and debt.

pricing for the three former areas. The choice therefore is between wholly cost-reflective charging (which will disadvantage the smallest and most rural) and fully harmonised charging.

- Businesses, like households, should not be asked to pay more solely because of their location.

- The distinction between some households and non-domestic customers was blurred, for example people who work from home, farms and crofts, owners or managers with accommodation in hotels or on school and business sites.

It still seems to us that it would have been difficult for Scottish Water to defend having different pricing regimes in different parts of Scotland.

Regulation and financial control

Over the past four and a half years we have dedicated significant resources to establishing a robust and objective regulatory reporting regime. We were fortunate that we could draw on the information contained in the Annual Return to write the *Strategic Review of Charges 2002-06*. This was the first time that such standardised information had been available. In the past two years we have made a considerable effort to improve further the overall quality of management information. This will be crucial to improving the financial and customer service performance of the industry.

Improved monitoring

Monitoring performance is central to regulation. This explains why we sought ministerial approval for the annual reports on the performance of the industry in Scotland and for a joint project with the quality regulators to agree how the outputs of the capital investment programme should be monitored. Increased information about performance is only valuable if, as a result, customers get a better level of service or the costs of the industry can be sustainably reduced.

Performance monitoring has developed significantly in last the two years. This monitoring takes two forms: ongoing collection and analysis of information; and publication of annual reports on:

- Costs and Performance;

- Investment and Asset Management; and

- Customer Service.

These reports are objective analyses of the current performance of the industry in Scotland. We believe that our performance monitoring has already brought results. Scottish Water performed much better in its second year than initial drafts of its business plan suggested were possible. Our monitoring of the capital programme will also ensure that we can manage the transition from the *Quality and Standards II* to the *Quality and Standards III* period effectively. This will ensure that there will be no question of customers paying twice for the same promised improvement.

Better governance

We believed that better governance would be vital if the performance of the Scottish industry was to improve. It is encouraging that the Scottish Executive has adopted many of our recommendations from the last Review.

We made **five** principal recommendations. These recommendations and the current position are outlined below.

Recommendation:

There should be well-defined responsibilities for the Scottish Executive's de facto ownership role, the board and the senior management, ensuring that accountability of each party is rigorous and transparent.

Current position:

The Scottish Executive is introducing a much clearer regulatory framework. Ministers will take clear decisions on the levels of investment and investment priorities. They will also provide guidance on how customers should pay for water and where they want to see cross-subsidies.

Scottish Water will have to draft a business plan that takes full account of the guidance from Ministers and outline their strategy objectives and views on prices for the next regulatory period. This business plan will have to be approved by the Board. The Board will have to present this plan to the economic regulator. Ministers will use a first draft of this plan to inform the guidance that will underpin the second draft.

Recommendation:

There should be high-quality, commercially experienced non-executive board members who will bring openness, thoroughness and objectivity but also be able to question and advise senior management when necessary about the operation of the business.

Current position:

The Board of Scottish Water has eight non-executive members. These members bring extensive experience of different business sectors and sizes. In particular, they have significant expertise in utilities, asset management and finance. The Board can also draw on important expertise in large change programmes and human resource issues.

Recommendation:

The right balance should be struck between executive and non-executive directors. The Board is crucial in supervising the drive for efficiency.

Current position:

There are eight non-executive and five executive members of the Board.

Recommendation:

There should be transparent and appropriate incentives and penalties for executive board members and for senior management to ensure that the right calibre of professionals is attracted to the industry

Current position:

Senior management can earn bonuses. The remuneration committee of the Board sets these bonuses based on performance criteria established at the start of the year. In Scottish Water's Annual Report for last year, information was provided about how individual bonuses had been calculated.

There may still be room to improve the transparency of the incentive system. Best practice would suggest that the performance measures that will be used to determine bonuses will be published in advance and should be independently measurable and verifiable.

Recommendation:

There should be clear setting of the risk profile by the owner, followed by management of risks by the board to the criteria established by the owner.

Current position:

The strengthening of the governance and regulatory framework described above should ensure that this recommendation is met.

Inevitably there were some unexpected consequences of the actions that we recommended. One example would be the size of the percentage increases in bills for some non-domestic customers. While we recognise the concerns of these customers, it is not clear that we could have acted differently. We have to balance the interests of all customers and every customer who pays below the average cost of supply for the service that they receive is gaining at the expense of other customers. It is important to remember that even if the difference in tariffs had been reduced by half, water customers in the North would have been paying some 40-50% more for the water that they consumed.

The methodology for the 2006-10 Strategic Review of Charges will build on the solid foundation created by our work in 2001. We will use the improved information that is now available to broaden and deepen the analysis that we were able to complete for the last Review.

Resource accounting and the Strategic Review of Charges 2002-06

In reviewing the outcome of the *Strategic Review of Charges 2002-06*, it is important to explain the impact on customer bills of the introduction of resource accounting. In recent months, this topic has been discussed in detail by the Parliament's Finance Committee. We believe that the introduction of resource accounting did not have an impact on the prices paid by customers. Indeed, the introduction of resource accounting led to increased scrutiny of the value of assets owned and the depreciation policies used by the industry. This will have contributed to the progress of the past few years towards a more sustainable public sector water industry that can continue to meet the expectations of customers.

Resource Accounting and Budgeting (RAB) was fully introduced in April 2001. The Minister's commissioning letter for the 2002-06 Strategic Review of Charges set public expenditure limits on a resource accounting basis. It also made clear that we should regard these as maximum limits and that we should demonstrate, by means of risk analysis, that our advice on charges was consistent with these maximum limits.

The introduction of resource accounting did not directly impact on the way in which either the three authorities or Scottish Water managed their businesses or prepared their accounts. The three authorities had always prepared their accounts on an accruals basis. Resource accounting did change the financial control figure that the Scottish Executive used. Instead of monitoring the extent of new borrowing required (refinancing of existing debt at maturity does not count as public expenditure), the Scottish Executive began to measure consumption of resources and capital spending.

Clearly the way in which a company is monitored or analysed does not impact on either its accounts or its underlying business. Consequently, providing that the control total has been correctly adjusted to reflect the difference in how it is calculated, this should have had no impact on the company or the prices that it needs to charge.
We were confident that the public expenditure control figures included in the letter were consistent with the approach that had been outlined by the Treasury and that they had been adjusted upwards to take account of the difference in the way in which the control figures were calculated.

Subsequent events have shown that sufficient public expenditure had been made available to cover any likely underperformance. The end-year flexibility allowed by the Scottish Executive has also allowed this expenditure to be used when required. We have to conclude, therefore, that the level of public expenditure that was made available by Ministers did not adversely impact on customer charges.

Performance monitoring

An important improvement in the regulatory framework for the water industry in Scotland in recent years has been the introduction of performance monitoring mechanisms. In England and Wales, Ofwat monitors and reports on the performance of the companies on a regular basis. Ofwat also sets targets for improvement that are, at least in part, driven by comparisons between the companies. Investors are very interested in these reports because they provide an objective source of information about the prospects of the companies. However, investor reaction to news from a company could alert Ofwat to an issue that may not yet have surfaced in a regulatory return.

In the public sector model, the absence of investor scrutiny makes our performance monitoring even more important. This explains both our recommendation to the Minister that we should publish annual performance reports, and the resources that we have invested in regulatory systems.

Shortly after the formation of this Office in November 1999, we signalled[5] our intention to establish a mechanism to ensure that it would be possible to carry out rigorous comparisons between the water authorities

[5] In the interim Strategic Review of Charges published by the Water Industry Commissioner for Scotland in early 2000.
[6] See Chapter 2, 2.2: 'The collection and use of information'.

and between the industry in Scotland and in England and Wales. The subsequent 'information project'[6] led to the creation of a Scottish version of the June return which is submitted to the Ofwat. This return provides a comprehensive set of financial, asset condition, capital investment and customer service indicators, which allow us to monitor and report on Scottish Water's performance.

We included two key recommendations to strengthen performance monitoring further in our advice to Ministers contained in the *Strategic Review of Charges 2002-06*[7].

1) To endorse a joint project between the Water Industry Commissioner, Scottish Environment Protection Agency and the then proposed (now established) Drinking Water Quality Regulator to ensure that consistent output measures and metrics are collected and monitored.

2) To require the publication by this Office of annual reports on the performance of the water industry in Scotland. These reports would cover operational costs, delivery of investment and the level of customer service.

We have also built up a range of other performance monitoring activities, which help to improve our understanding of how well Scottish Water is performing:

- Monthly financial returns – these financial reports provide a detailed breakdown of Scottish Water's financial performance over the preceding month and progress against annual budgets;

- Quarterly returns on progress with the capital investment programme – provide an update on progress, at a project level, with delivery of the capital investment programme;

- Audits of Scottish Water's investment appraisal process; and

- Customer service performance audits – provide an assessment of Scottish Water's performance across a range of customer service measures.

We are committed to ensuring that customers get better value for money and to this end we intend to work to strengthen our performance monitoring in the area of investment delivery. We will also need to adapt our processes to take account of future changes in legislation and the regulatory framework, such as the introduction of a competition framework and the development of regulatory accounts.

- The introduction of regulatory accounts

  The Strategic Review of Charges 2006-10 will focus only on the core activities of Scottish Water in providing water and sewerage services to customers in Scotland. This change reflects the requirements of the Water Industry Act 2002, which restricts our role to promoting the interests of customers of the core business. We have begun to establish regulatory accounts, which will ensure that customers of the core business are only paying for services associated with core activities. This work will be completed during the current financial year.

- The introduction of a competition framework for the water industry in Scotland

  The proposed changes to the competition framework contained in the Water Services (etc) Scotland Bill will also require a further level of accounting separation. This framework will require there to be a clear split between the retail (customer service and billing) costs and the wholesale (network management and operation of treatment plants) costs.

Both of these developments will improve the quality of information provision and hence the robustness of our analysis.

The 'ten principles'

Successful performance monitoring, and hence successful regulation, relies on the existence of an

[7] Strategic Review of Charges 2002-2006, Executive Summary Page 3 section c) 'Key recommendations'.

agreed set of targets, which the regulated company (in this case Scottish Water) is required to achieve. Without agreement on these targets, performance monitoring and reporting becomes difficult and regulation will not be effective. This impacts directly on customers and stakeholders, as it is the existence of clear targets that drives regulated companies to tackle inefficiencies, deliver investment and achieve customer service improvements.

The Transport and Environment Committee of the Scottish Parliament reviewed the operating cost efficiency targets early in 2001. The Committee heard evidence from the three former water authorities and from the Scottish Executive, all of whom regarded the targets set out in the Review as achievable. It also heard from a range of other stakeholders, who did not express a view, and from the unions represented in the water industry. The unions regarded both the method of benchmarking and the resulting targets as unreasonable. After a long and detailed enquiry, the Committee concluded that the targets were challenging but fair.

The *Strategic Review of Charges 2002-06*, which was published in November 2001, advised on revenue caps both for the three authorities and for the proposed Scottish Water. The Review therefore established the regulatory targets for Scottish Water in the period to 2006.

Scottish Water is required to produce an annual business plan for approval by Ministers, which sets out the Board's strategic aims for the company and contains details of the key financial and delivery targets for the business.

In early 2003, Scottish Water submitted its proposed business plan for the three year period from 2003-04 to 2005-06. In March 2003, the Minister wrote to the Commissioner requesting that he consider representations from Scottish Water about its strategic business plan. In particular, the Minister noted that Scottish Water's proposed business plan suggested that Scottish Water's operating cost targets would be different from those set out in the Strategic Review of Charges. This would have resulted in increased borrowing, with no extra benefits for customers and increases in future charges.

We received written representations from Scottish Water. We also met with Scottish Water to discuss these representations. In our response we pointed out that the operating cost projections contained in the Scottish Water strategic business plan would have led to price increases of around £40-£50 in 2006-07 for the average domestic customer. We explained that we considered this neither justifiable nor acceptable. We also concluded that Scottish Water's business plan did not provide a sufficient degree of financial sustainability to ensure the longer term success of the company. This is clearly not in customers' interests.

We had to find a settlement, which protected the customer interest, and would also be acceptable to Scottish Water. This led to the agreement of ten principles.

Principle 1

Operating costs for the whole year 2005-06 should be at a maximum of £265 million, which is £7 million above the £258 million WIC monitoring target set in the Strategic Review. The £7 million allows for factors that were unknown at the time of the Review and comprises £4 million additional allowance for the higher operating costs position inherited by Scottish Water and £3 million for the different legal status of lateral sewers in Scotland. This will provide a significant protection for customers against future unnecessary price increases. In reporting the operating cost performance of Scottish Water, the Commissioner will comment upon progress towards this figure.

Principle 2

Scottish Water's total debt at the end of the Strategic Review period may rise to a maximum of £2.47 billion. This level of debt includes an amount of up to

£112 million reflecting estimates of projected price inflation (above 1.5%) in the cost of capital goods. The range will increase to a maximum of £2.71 billion when the remaining £235.2 million (post-efficiency, £305.5 million pre-efficiency) of 'red'[8] projects in the WIC 18 capital investment programme are approved by all stakeholders for inclusion in the programme

Principle 3

Scottish Water and the Commissioner will agree schemes of charges for both 2004-05 and 2005-06 in the near future, in such a way as to include price caps that are consistent with the revenue caps agreed in the Strategic Review. The purpose of this provision is to provide customers with a greater measure of certainty about their forthcoming bill. In addition, Scottish Water and the Commissioner will establish a mechanism to adjust future schemes of charges for over-collection and under-collection of revenue.

Principle 4

A Reporter of regulatory information will be appointed as soon as practicable. The Reporter will operate in a fashion similar to Reporters in England and Wales. The Reporter should be appointed by the Commissioner and would be chosen from amongst persons that have served at least three years as an Ofwat-named Reporter. The Executive will meet the cost of the Reporter.

Principle 5

Measurement of Scottish Water's comparative and improving efficiency will take place on the basis of the method established in the Strategic Review of Charges. Appropriate costs (subject to audit by the Auditor General) incurred in the pursuit of activities not undertaken in 2000-01 will be removed from regulatory operating expenditure to the extent that these costs are funded by revenues from these new activities.

Principle 6

Subject to the agreement of the Auditor General, the Commissioner and the Auditor General for Scotland will work closely to establish the nature of prospective regulatory adjustments, prior to the Auditor General commencing audit of Scottish Water's accounts. It is intended that the broad nature of forthcoming regulatory adjustments may be set out in a note in the accounts in addition to (but not substituting) information contained within the existing accounting requirements. The Commissioner will request that the Auditor General for Scotland audit the process by which the Commissioner makes adjustments to information contained within the accounts and regulatory return made by Scottish Water to the Commissioner. After consulting the Commissioner and Scottish Water, the Executive will seek the views of the Director General of Ofwat on the nature and scope of adjustments that should normally be made to audited accounts for purposes of regulatory comparison

Principle 7

Scottish Water will agree to work with the Commissioner to put in place a range of measures to assist the improvement in their relationship. This is likely to include various matters, including for example, the sharing of reports prior to publication (for the purposes of factual comment), the provision of regulatory and other information to the media, and other mutual mechanisms for resolving routine working issues as they arise.

Principle 8

Non-core activities that are new in nature or additional in extent to those passed to Scottish Water by the former Authorities may be pursued by Scottish Water (subject to the approval of Scottish Ministers) on the basis that they are funded by performance in excess of the agreed minima, taking into account progress towards the target for the end of the period.

[8] 'Red' projects are projects originally included in *Quality and Standards II* that DWQR and SEPA had decided were no longer required. New outputs will be substituted.

Principle 9

The Executive will investigate setting up a prospective appeal mechanism to the Competition Commission.

Principle 10

Scottish Water will engage with the Commissioner in improving the quality of data supplied to the Commissioner.

In reaching an agreement on the ten principles, we were adamant that any proposal should be consistent with the customer interest. We believed that this process should either improve our ability to undertake regulation, or improve the likelihood that Scottish Water would achieve its efficiency targets. The ten principles achieve these objectives by providing a framework for improving regulatory information and by establishing a common understanding of Scottish Water's targets.

The use of borrowing in the Scottish Water Industry

There has been a great deal of discussion about whether or not the industry should borrow more and reduce prices to customers. It is important to look not only at the short-term price benefit that could be achieved by increasing borrowing but also to consider the increased exposure to risk, the potential disincentive to improve efficiency and the future level of prices before concluding that borrowing a lot more now is in the interests of both present and future customers.

The Scottish water industry is cash negative: that is to say it spends more than it receives in customer charges. This situation is likely to continue for the foreseeable future. As debt increases, so too does the total interest bill that must be met by customers. Managing debt at prudent and sustainable levels is therefore critical if the industry is to be able to respond to operational shocks.

A company will borrow when it is short of cash. This may be for short-term operational reasons (eg to cover working capital until goods or services are paid for) or for investment. If a company borrows for operational reasons, the company has to budget for the interest costs and the repayment of principal. If a company uses debt as a source of funds for investment, management has to make sure that the additional return on the investment covers the interest payment and, ultimately, repays the capital.

In either case, the company is committing its future income to pay for today's cash resources. It is important to remember that debt is not an additional source of revenue.

Consideration of the prudency of increasing debt is more complicated in a regulated business. An economic regulator seeks to ensure that customer charges are set at the lowest level consistent with a sustainable business. He will therefore typically only allow an increased return (ie increased revenue from customers) to be earned by a company if there has been a net increase in the total asset base. As such, borrowing any more than this net increase in the total asset base would not be prudent. If a company continued to borrow in excess of the net new assets created, it would not take long for the revenue that its regulator allowed to be less than its outgoings (not including new investment). In a private sector context insolvency would follow.

In a public sector model, the trade-off between debt and equity returns is not an issue. All retained earnings will remain in the business and will be used to the benefit of customers. In a regulatory capital value model, customers pay a charge that depends upon the level of investment, the depreciation of the asset base, a rate of return on the regulatory capital value and allowable operating costs. The level of debt does not influence charges directly.

As new investment is added each year, the total value of the regulatory capital value will increase each year. Charges will gradually increase over time to reflect the larger capital value that needs to be remunerated. Customers do not therefore pay for the use of an asset before it has been added to the regulatory capital value. If the proportion of debt to regulatory capital value stays the same, there is no inter-generational wealth transfer. Moreover, if the cost of capital allowed on the regulatory capital value is the same as the borrowing cost of the public sector company, there should be no advantage to increasing debt (beyond increases allowed as the regulatory capital value increases).

Debt commutation

Many commentators have asserted that the Scottish water industry was unfairly treated in the amount of debt commuted at its reorganisation in 1996. The argument is that in England and Wales the water authorities had all of their debt written off before they were privatised, whereas less than half of the total water and sewerage debt accumulated by the Regional and Island Councils was commuted. This assertion does not bear scrutiny. Indeed, the Scottish water industry seems to have received a significantly better deal than the industry south of the border.

At privatisation in England and Wales, net debt of £4.95 billion was commuted[9, 10]. In addition, the Treasury provided a cash injection (known as the 'green dowry') of £1.57 billion. The total cost of the transaction before the proceeds from privatisation was £6.52 billion. This is equivalent to £275 for every household in England and Wales. Privatisation raised £5.22 billion. The net cost to the Treasury of the reorganisation of the water industry, therefore, was £1.3 billion. The net cost per household was approximately £55. The Treasury also transferred accumulated tax losses of £7.76 billion to the companies, but this did not have a cash cost to the Treasury.

Financial reorganisation in Scotland was more straightforward. When the three water authorities were created in Scotland, the Treasury commuted some £700 million of a total of £1,700 million of local Regional and Island Council debt relating to water and sewerage activities. This left £1 billion debt on the starting balance sheets of the three authorities. Clearly there were no receipts from privatisation to reduce the costs of the restructuring. The total cost to the Treasury from this reorganisation was therefore £700 million. This amounts to more than £330 per household. The cost to the Treasury was therefore around six times greater than that incurred reorganising the water industry in England and Wales.

At the time of the Strategic Review, the industry in Scotland had £1.7 billion in tax losses. These were proportionately more than in England and Wales. These tax losses were transferred to Scottish Water by the Water Industry (Scotland) Act 2002.

It has also been argued that the Scottish water authorities were unfairly treated because of the high cost of debt after 1996. This argument again does not stand detailed scrutiny because the average interest charge on the debt compares very favourably with the returns that were offered to potential shareholders to ensure that privatisation was a success.

The public sector industry in Scotland will also continue to benefit from access to cheaper borrowing. The interest rate charged to Scottish Water is usually around 0.2-0.4% lower than the equivalent rate for the highest quality private sector debt.

The impression that customers in Scotland have been disadvantaged can only result from operational and capital inefficiency.

In our most recent Costs and Performance Report, we noted that out of an average domestic bill of £241, £80 or 33% was the direct result of inefficiency. This means that customers paid more than £300 million to finance inefficiency. The costs of this inefficiency were greater than the net new debt taken on by the three authorities. In real terms the customer has received no value for the extra debt accumulated and it follows that the industry's finances have been made less sustainable by this increase in borrowing.

Transparency in the level of debt

From a customer perspective, it is important that the industry is managed on a sustainable basis. This requires that management must face a hard budgetary constraint.

A hard budgetary constraint will also impact on the owner of a business. The owner needs to take difficult decisions in the event that performance (for whatever reason) lags behind what is expected. Providing some more short-term capital may be part of the solution but

[9] £5.02 billion was commuted and £72.9 million of new debt issued in favour of the Treasury
[10] Two bonds, one valued at £61.0 million and a second at £11.9 million were issued to the Treasury by Anglian Water plc and Thames Water plc.

there will also be a need to ensure that other steps are taken to ensure that performance reverts back to an acceptable standard. The ten principles are a good example of such decisive action

Finance Committee Investigation

In recent months, the financing of the water industry in Scotland has come under scrutiny by the Finance Committee of the Scottish Parliament. Consideration of the findings of the Committee will form an important part of the next Strategic Review of Charges.

In November 2003, the Finance Committee agreed the following remit for an investigation by two of its members.

“To investigate the following issues:

- accountability – looking at the role of the Water Industry Commissioner, the relationship with Scottish Water, the Scottish Executive and local authorities;
- structure – looking at water charging and debt management;
- investment – looking at capital projects, the profile of procurement and borrowing, billing and financial management; and to suggest potential areas for the questioning of Scottish Water and the Water Industry Commissioner….”

The Committee published its report in April 2004. The Scottish Executive made an initial response almost immediately and a further response on 14 June 2004. We responded to the Committee at the beginning of June 2004.

Reasons for the investigation

There had been an increasing amount of press attention to water industry issues during 2003. The issues raised included:

- delivery of investment and an apparently increasing number of development constraints;
- disagreements between this Office and Scottish Water on its performance;
- the large increases in charges that some small businesses had faced – this had become a high profile issue, with representative organisations such as the Federation of Small Businesses and the Scottish Forum for Private Business raising concerns; and
- a paper written by Analytical Consulting Ltd and submitted to the Finance Committee, which suggested that public expenditure rules had been incorrectly applied and that customer charges were higher than necessary as a consequence.

The Committee’s findings and our response

A copy of the Committee’s report is available on the Scottish Parliament’s website (http://www.scottish.parliament.uk/finance/index.htm). The Committee made twenty one recommendations as a result of its inquiry.

We welcomed the Committee’s report and its scrutiny of the water industry in Scotland. In our view this report should help ensure that all customers will benefit from a more sustainable water industry.

We agree that the strengthened regulatory regime should be more clearly accountable to customers. The current role of the Water Industry Commissioner for Scotland, as defined by statute, is to advise Scottish Ministers and to approve schemes of charges proposed by Scottish Water so long as they are consistent with the advice provided to, and accepted by, Scottish Ministers. This advice is provided within a defined policy framework (for example, that there should be a link between domestic water and sewerage charges and Council Tax bands).

In evidence we suggested that economic regulation should work in broadly the same way as for other utilities. This model requires that Ministers provide clear guidance on social, environmental and public health priorities and that the regulator should then manage a transparent process, which leads to decisions on the maximum prices that can be levied on customers. Scottish Water should have the right of appeal to the Competition Commission. This very clear process is likely to reduce the current uncertainty amongst stakeholders on roles and responsibilities.

The Committee also made a number of other observations. Their observations, and our responses, are detailed below.

28. It is clear that the optimistic forecasts of minimal price impacts from harmonisation of prices across Scotland were not realised. Efficiency gains from the greater economies of scale should have minimised any price impact. Instead between 2001-02 (the last year of the three separate authorities) to 2004-05 (the current year and harmonisation of prices at £338.31) customers in the East are paying 25.3% more (£68.31), customers in the West are paying 27% more (£71.91) while the North is paying marginally less –3.4% (-£11.87). This is at variance with the estimate provided by the WIC. The Committee is not convinced of the WIC's estimate and explanation of the impact of harmonisation on customers in the East and West

We can confirm that the estimate that we supplied to the Committee, on the impact of harmonisation on the value of the average domestic bill, is accurate. There would appear to be two principal reasons for the misunderstanding. Firstly, the Report includes a table that details changes in the Band D bill – this is significantly higher than the average domestic bill, which is between the Band B and the Band C levels. Secondly, the substantially increased level of investment included in *Quality and Standards II* resulted in an overall increase in prices that could only be partially offset by the efficiency targets that were set for capital and operating costs.

35. The Committee is concerned that there does not appear to be agreement between the WIC and Scottish Water on how much progress is being made with regard to efficiency savings and operating costs and is also concerned over what the impact could be if the necessary savings are not met.

The Committee is correct to be worried about the impact on future prices of a failure to meet the efficiency targets that were set in the Strategic Review of Charges.

It is however not uncommon for there to be disagreement between the regulator and the regulated organisation about both the level of the efficiency target and progress towards that efficiency target. Our role is to monitor progress of Scottish Water on a fair and objective basis. Customers can therefore be assured that comments from this office will be supported by appropriate evidence and underpinned by a consistent methodology.

59. While the Committee understands the Scottish Executive's reasons for promoting the equalisation of domestic bills across Scotland, the consequences in terms of increased charges were not adequately explained to consumers and appear to have been underestimated.

Astonishingly, the impact of the harmonisation of business charges on low volume business users appears not to have been foreseen. No economic justification for business charge harmonisation was given either by Ministers or the WIC, despite its significant impact on firms adversely affected. The failure to openly debate and consult on harmonisation and the specific harmonisation methodology that was implemented for business users, as well as the failure to introduce such a significant change on a phased basis, has caused a great deal of distress to small businesses.

The desirability of harmonised charges was recognised in the discussion that followed Sam Galbraith's announcement to the Transport and Environment Committee in February 2001 of the Scottish Executive's intention to create Scottish Water.

We accept that many of those who faced sharp increases in bills believe that there was insufficient debate and consultation about the change in tariffs. Any such change in tariffs is likely to be unpopular with those who end up paying more and accepted as right and proper by those who benefit. In this regard, while we can sympathise with businesses who were asked to pay more, we also believe it is important that we remember that there were many businesses that benefited from the change in tariffs and that they had been paying relatively higher (than others of a similar type and pattern of usage but located in another authority area) bills since 1996.

During our programme of consultation, we received many representations from businesses and business representatives that differential charging based on location was unfair.

In evidence, the Finance Committee heard that "..it is an unusual notion that would take a strategic asset like water and say that, no matter whether someone lives in Rannoch or the top of the Cairngorms, the same pricing policy will exist for all" (paragraph 57). However, other utility businesses operating in Scotland do precisely that. Scottish Gas and BT apply the same charges across the whole of Scotland, while the Scottish electricity companies (Scottish Power and Scottish Hydro-Electric) each apply the same tariffs throughout their respective areas. It would seem not unreasonable, therefore, for Scottish Water to apply uniform tariffs, regardless of location. Certainly considerable thought should be given to the implications of the location signals that would be given to developers of encouraging a major water user to locate, say, in North Fife (a high cost water area) rather than in, say, Dundee (a low water cost area).

80. The Committee recommends that to give the public greater confidence in the quality of the consultation carried out, both Scottish Water and the WIC should operate under clear consultation codes with consistent approaches to publication of responses. In particular, all consultation submissions made to the WIC should be made public before any of his statutory reports are released and the WIC should address the relevant issues raised by consultees within the reports themselves. In this way, the public can be reassured about the conduct of the relationship between the WIC, Scottish Water, its customers and the Scottish Ministers.

We agree that the introduction of such a code would be of benefit. Our Office will prepare in draft and consult on such a code. It would be useful to formalise this in statute in the forthcoming Bill.

83. The Committee believes that it would aid the accountability and transparency of the WIC in the view of many customers if he had to give a formal response to submissions from the Panels, which could also be lodged with the Parliament.

We would agree that this proposal could bring benefits. There would, however, be a resource implication associated with preparing an appropriate detailed written response to all submissions.

84. The WIC is both financial adviser and guardian of the public interest but was unable to provide the Committee with a clear illustration of how the public interest is determined where different interests have to be balanced. For example, weighing lower prices to the customer against the long term sustainability of the water supply network is an important decision that has been taken with little public debate.

In our evidence to the Committee, we explained that our role is technical, not political nor representational of particular groups (as opposed to customers as a whole). This technical role should ensure that the aims of Ministers are delivered, for the lowest justifiable cost to all customers.

The Strategic Review drew on guidance from Ministers on the level of performance expected from the water and sewerage network. *The Quality and Standards II* process provided the vehicle for this guidance.

85. The Committee is concerned that there is a lack of transparency in the way in which the roles of

the WIC as regulator and customer champion are combined and that there is a perception in the minds of at least some stakeholders that there may be a conflict of interest between the WIC's stated role as a champion of current consumers and being a vital element in the drive for the water industry's long term efficiency.

The statutory duty of the Water Industry Commissioner for Scotland is to promote the interests of customers. Our principal weapon in promoting customer interests is to challenge the industry to improve its efficiency and to improve its level of service. The remit of the Office does not extend to supporting the interests of one group of customers when this would disadvantage others.

Throughout the regulated industries, the recognition of the potential conflict of interest between regulator and 'customer champion' to which the Committee seems to refer has led to the creation of separate customer bodies such as Energywatch, Postwatch, Rail Passengers' Council, WaterVoice and, in Scotland, the Water Customer Consultation Panels (WCCPs). We welcomed the creation of the WCCPs as it brings clarity to the role of promoting customer views and the representation of particular customer groups.

87. The current WIC told the Committee that a subsequent WIC may take a wholly different approach to providing advice on a charging structure. This is not conducive to long term planning for the industry, continuity of the office and neither does it display much thought to the representative nature of the WIC in making advice.

The nature of our role is to promote the interests of all customers now and in the future. WICS does not have a representative role; the WCCPS has a duty to represent the views of customers.

88. The Committee believes that an improved structure and support for the WIC is needed to ensure independent regulation and transparency across the industry. Modelled on some of the English and UK regulators, an Office of the Water Industry Commissioner, including a non executive membership, could provide greater accountability and continuity for the Scottish water industry. Consideration should be given to whether certain decisions should be taken by the WIC in the context of advice from Ministers rather than the reverse.

We agree. We have been advocating for some time that, in the interests of customers, the water industry in Scotland should be regulated in a way that is more transparent and accountable, consistent with UK regulatory policy.

129. When the WIC was before the Committee, he implied that his financial limits were not particularly stringent in the light of what the English regulator did and in the light of the sorts of ratios that were achieved by water companies in the commercial sector in England and Wales. However, there was concern expressed by members of the Committee that the basis of comparison appeared to be different and therefore the Committee sought clarification from the WIC about the basis of comparison between financial ratio targets set in Scotland compared with those in England and Wales and found that there were very considerable differences between the bases on which these targets were calculated, invalidating the comparisons which had been suggested. In a letter to the Committee dated 27 February 2004, ACL highlighted that the basis used for Scotland is "revenue – less operating expenditure". Whilst broad financial ratio analyses can add clarity in making comparisons, they can be misleading where non-comparable bases are used to assess performance. The Committee found unacceptable the WIC's use of comparisons between Scotland and England and Wales without making clear the impact of different bases of calculation. Where different bases are used this should be fully explained to ensure transparency.

Having reviewed our oral evidence, we would agree that we should have been clearer about the basis of calculation of the respective ratios in Scotland and south of the border. The comparison was designed to indicate the ability of the industry in Scotland and south of the border to withstand shocks and, as such, it would not follow that the comparison was invalid.

Lessons learned from the Strategic Review of Charges 2002-06 and the response of stakeholders

The *Strategic Review of Charges 2002-06* highlighted a number of challenges:

- the need to improve efficiency;
- the potential threat of competition;
- the need to improve understanding of the condition and performance of assets; and
- the desirability of improving the financial sustainability of the industry.

The industry has responded well to all of these challenges and customers can look forward to much improved value for money as a result. Not surprisingly, some stakeholders have criticised the Review and some of the steps that have been taken to meet the challenges highlighted in our analysis.

The areas of criticism have included:

- the process of harmonising charges;
- the increase in fixed charges;
- the industry should have been allowed to borrow more;
- the efficiency targets were unreasonable;
- a lack of clarity in roles and responsibilities; and
- a lack of explanation.

In preparing the *Strategic Review of Charges 2006-10*, we are keen to learn lessons from the criticism that has been made. We do not expect that all stakeholders will like all of the contents of the next Review, but we are keen to improve the understanding of our role.

We believe that the *Strategic Review of Charges 2002-06* set a framework that was appropriate and in the interest of the customers of today and in the future. There has been a marked improvement in the industry's efficiency and in its understanding of its assets. We believe that the Review made a significant contribution to encouraging these improvements.

However, we do believe that there are a number of steps that we can take to improve the transparency, accountability and perceived proportionality of regulation.

Transparency

Improving process

In July we published *Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges 2006-10*. This described our work plan in some detail and highlighted all of the information that we collect from Scottish Water. It also gave information about the opportunities for stakeholders to learn more about our work and to ask questions.

Perhaps the most important part of the process begins with the publication of our draft advice/determination at the end of June next year. This will be followed by a period for representations about this answer from stakeholders. Our final advice/determination will be published at the end of November. These prices will take effect from the beginning of April 2006.

Better explaining our approach

We have arranged a large number of stakeholder information days. These half-day sessions will provide an opportunity for us to explain where we are in completing the Strategic Review of Charges. We hope that these sessions will also provide an opportunity for stakeholders to raise their concerns or issues with us. We will respond to all such issues raised with us at a stakeholder information day.

Ensuring that stakeholders can understand the answer

There are three important ways in which we can ensure that stakeholders can understand the answer. Publishing all of the key inputs to the Review will be important. However, we will also endeavour to present the answer in a way that will allow stakeholders to understand what the answer means for them and for customers as a whole. We will also outline our reasoning and reference the evidence upon which we have relied to come to our answer.

We also note comments from some commentators that they found that our reasoning in the last Strategic Review of Charges was not complete. The next Strategic Review of Charges will provide sufficient information for all of the major findings of the Review to be replicated.

Providing opportunities for comment

There are three main ways in which we will provide stakeholders with an opportunity to comment. These are the stakeholder information days; the publication of our proposed methodology; and the period for representations after the publication of the draft advice/determination. Each of these will play a valuable role in allowing us to hear the views of stakeholders. We would encourage stakeholders to use these opportunities.

Accountability

Explaining the role of this office and other stakeholders

We believe that the Scottish Executive's proposals to strengthen the regulatory framework in Scotland will help improve both actual and perceived accountability. The establishment of a Commission should depersonalise regulation – a Commission arriving at a joint decision is always likely to be considered more accountable than an individual with a similar power.

The proposal to give the Commission the power to decide prices subject to ministerial guidance is welcome. This will ensure that authority and responsibility are aligned.

Proportionality

There has been a concern from some quarters (principally Scottish Water in its first year and the trades' unions) that our analysis lacked proportionality. The assertion was that we had adopted regulatory tools from south of the border and blindly applied these in Scotland, taking little or no account of the maturity, geography and asset base or of the public sector nature of the water industry in Scotland. Similarly there was a concern about how quickly we asked Scottish Water to narrow the efficiency gap.

We did explain our method for assessing how quickly Scottish Water should close the efficiency gap in some detail. Looking back, it may also have been helpful to re-emphasise the importance of spend to save in making our rate of catch-up less demanding.

In the *Strategic Review of Charges 2006-10*, we will pay particular attention to issues around comparability of companies, costs and levels of service. We will seek to set targets that are proportionate and take full account of factors that would both increase or reduce the targets.

Powers of determination

The Water Services etc (Scotland) Bill, introduced in June 2004, proposes a number of important changes to the regulatory framework. Its objective is to strengthen the regulatory framework for the water industry, and to ensure that there is a robust and transparent regime that operates in the interests of all customers. The Bill includes measures to improve the accountability and transparency of the regulator, including replacing the current individual Water Industry Commissioner with a body corporate, the Water Industry Commission for Scotland. The Bill then goes on to give the Commission powers of determination over Scottish Water's charges.

This 'power of determination' is a duty on the regulator to set prices. The Commission will operate subject to ministerial guidance. There are also proposals to allow

Scottish Water a right of appeal against the Commission's decisions to the UK Competition Commission.

The Competition Commission is an independent public body with the technical, economic and legal expertise to adjudicate in disputes between companies and their regulators. Its involvement helps to ensure that the charge setting process, carried out in the knowledge of a possible referral, is robust and transparent. If a case is referred to them, their decision will be binding. This check also ensures that regulators' decisions are subject to appropriate expert scrutiny.

We believe that this proposed right of appeal for Scottish Water would ensure that any challenges to regulatory decisions could be assessed in an objective and independent way.

Stakeholders could also seek a judicial review of the regulator's decisions. In principle, the purpose of judicial review is to guard against abuse of position by ensuring that the powers and duties of government and other public bodies are exercised consistently and within their legal bounds.

Effective regulation is in the interests of both customers and industry stakeholders. The creation of a Water Industry Commission for Scotland to take collective responsibility for the Commissioner's functions is in line with the restructuring proposed for the England and Wales water regulator. It is also consistent with the Board structures already established for other regulators. Like other sectors, the Commission will benefit from a high level of relevant experience from its future non-executive members.

The proposals regarding the introduction of powers of determination contain some material differences from the equivalent powers in England and Wales. From the standpoint of customers, the most significant difference involves Scottish Water's ability to borrow money. In most other regulated sectors, companies are freely able to access debt, subject only to conditions in the debt markets. Most other regulators do not have to adjust prices to take account of constraints on new borrowing.

The current proposals for Scotland would mean that Scottish Water is still subject to public expenditure limits. It is possible that in the future, it may be prudent for Scottish Water to borrow more than Ministers may be able to allocate in public expenditure. This would lead to an increase in customer charges beyond that decided in the relevant Strategic Review of Charges.

Core and non-core services

In the Water Industry (Scotland) Act 2002 our remit was changed to cover only Scottish Water's core activities and customers. The *Strategic Review of Charges 2006-10* will therefore establish the funding requirements for the core business of Scottish Water – the provision of water and waste water services in Scotland. The targets will not include funding for any non-core activities such as providing domestic plumbing services or delivering services beyond Scotland.

We believe that this separation of core and non-core business is in the customer interest.

In the *Strategic Review of Charges 2002-06* we had reviewed the experience of the privatised water and sewerage companies in England and Wales in generating additional sources of business from non-core activities. We also looked at the development of non-core activities in Scotland and their success or otherwise. We concluded that investment in new business by Scottish Water would need to be approached very cautiously.

The financing for any new ventures in Scotland, whether a small opportunity for a start-up with potential for organic growth, or an acquisition, ultimately has to be obtained from customers of the core business or from the taxpayer. Our view was that commercial opportunities should be carefully assessed, because even if the venture appeared to generate a return relatively quickly, there may be hidden costs (such as costs to exit the business), which could adversely impact on customers' bills in the future. There is also a risk that senior management spend an undue amount of time on the newer activities.

The Water Industry Act 1991[11] sets out the duties, rights and powers of the companies in England and Wales. They have a duty to provide water and sewerage services but the legislation does not define exactly the limits on or extent of the core business. In addition to the legislation, companies in England and Wales operate under licence.

This requires that Ofwat has a view on what forms the core business. Its approach is set out in its Regulatory Accounting Guidelines. We expect to draw heavily on Ofwat's work as we to seek to ensure that there is a detailed definition of core activities.

In order to ensure that we promote the interests of customers of the core business, we will have to take a number of steps.

- Clearly define core activities;
- Establish a set of rules governing transfer pricing between the core and non-core activities; and
- Ensure that reporting is consistent with these definitions and rules and that this reporting is subject to rigorous monitoring and audit.

We have begun work on introducing regulatory accounts for Scottish Water. Regulatory accounts use standards, breakdowns and definitions designed to allow the regulator to fulfil his functions. They are used in most regulated utilities in the UK. These regulatory accounts will ensure that we are able to monitor effectively the separation of core and non-core activities.

An important area of work in introducing regulatory accounts will be the definition of transfer pricing rules. We would again expect that these rules would be broadly similar to those used by Ofwat.

Introduction of a framework for retail competition

An important consideration in formulating our proposals for the *Strategic Review of Charges 2006-10* will be the possible impact of the proposed framework for retail competition.

The Water Services etc (Scotland) Bill includes provisions requiring the Water Industry Commission to introduce and administer a regime to license retail competition for 'non-household' (business and commercial) customers. Subject to the Scottish Parliament approving these provisions we propose that the licensing regime should be in place in Scotland by April 2008.

Prior to that date, we expect that the Scottish Executive will require Scottish Water to establish a subsidiary to manage its 'non-household' retail activities, which the Commission will license from the outset. In these circumstances, we expect that retail competition will impact the whole of the period covered by the next Strategic Review of Charges.

Our analysis suggested that there were three principal risks faced by the water industry in Scotland as a result of the Competition Act.

- It was clear that the industry needed to improve its efficiency and allocate its costs accurately;
- We also believed that it would be better to establish a clear framework for how competition would work in the Scottish water industry. Inaccurate cost allocation or inefficiency represented a risk because it could lead a customer or a supplier to accuse Scottish Water of breaching the prohibitions under the Act; and
- Likewise, we considered that a framework, which made it clear what Scottish Water was allowed to do and clarified the policy position on environmental and public health protection, could also reduce the risk of a challenge under the Act.

We will set price limits for both wholesale and retail elements of the business that are consistent with our overall aim of minimising costs to customers while ensuring the long-term financial viability of the industry.

11 Amended by the Competition and Service (Utilities) Act 1992.

Trade effluent

Another development that will potentially impact on the next Strategic Review of Charges is the proposed change to the regulation of trade effluent charges. To date, tariffs for trade effluent have not been included in Scottish Water's scheme of charges and we have not played any role in regulating them. Instead, Scottish Water, exercising powers under section 29(3)(j) of the Sewerage (Scotland) Act 1968 has set these charges. In practice this has meant that the total amount raised from customers in trade effluent charges has been limited to the difference between the agreed revenue cap and the amount raised from the tariffs approved in the scheme of charges.

The provisions of the Water Services etc (Scotland) Bill 2004 provide for the Water Industry Commission to determine charges for all of Scottish Water's core services. As trade effluent is a core activity of Scottish Water, trade effluent charges are within these provisions. Consistent with that approach, the Bill provides for the repeal of section 29(3(j) of the Sewerage (Scotland) Act 1968, thereby removing Scottish Water's power to set trade effluent charges separately.

There are three types of waste water: surface water draining to sewers, foul sewage and trade effluent.

Surface water refers to the rainwater that drains from roofs, yards, pavements, roads and so on.

Foul sewage refers to waste water (either domestic or non-domestic customers) from toilets and washing facilities (sinks, wash basins, showers, baths, etc).

Trade effluent is liquid waste from industrial or other commercial activity. It can cover a wide variety of liquid waste. Trade effluent is more difficult to treat and can represent a hazard. Businesses must have the consent of the sewerage company before discharging trade effluent into public sewers.

Paying for trade effluent

Historically, trade effluent charges in the UK were based on the volume of the discharge. In 1976, the National Water Council and the Confederation of British Industry agreed the Mogden formula as a basis for trade effluent charges. This formula sought to increase the cost-reflectivity of the charges that were made for the treatment of trade effluent. The formula sets a higher charge for more concentrated effluent that will require a higher level of treatment.

As part of the *Strategic Review of Charges 2006-10*, we will seek to consult with trade effluent customers, appropriate representative bodies and Scottish Water about the appropriate way to regulate trade effluent charges as part of the determination of charges that we will be required to make.

Business plans

Customers and other stakeholders are entitled to expect Scottish Water to have well-developed, sound and clear plans for the business going forward. We require a clear business plan to inform our Strategic Review.

A business plan is a company or organisation's statement of its strategy for the future. It should present clearly its forecast of revenue and costs. A good business plan should reflect the circumstances of the business. The water industry is a long-term business. It has to look well into the future in order to ensure that this essential service will be available for future generations and at an affordable cost. It needs to plan to deal with long-term demographic, social, economic and other trends.

In order to inform our analysis of revenue, we have asked Scottish Water to provide us with a business plan. The business plan is an important opportunity for Scottish Water to influence the outcome of the Strategic Review of Charges.

In England and Wales, Ofwat requires the companies to submit detailed business plans. We have introduced a similar business plan requirement in Scotland. Our requirements are broadly similar but we have adapted them to the Scottish context.

Scottish Water will be required to submit a first draft business plan and a second draft business plan to us and to the Scottish Executive. The process for each of these submissions is essentially the same. The first draft business plan will enable us to do much of the preparatory work for the *Strategic Review of Charges 2006-10*. The second draft business plan will allow us to draw our conclusions on prices for the draft advice/determination of charges.

We expect Scottish Water to submit a draft business plan that contains a complete statement of its strategy. Our review will assess whether:

- the plan sets out a strategy consistent with the expectations on Scottish Water;
- the strategy has taken account of costs and benefits and considered possible risks;
- the plan shows a clear relationship between what is required of Scottish Water by legislation, guidance and stakeholders and its outputs;
- the outputs are clear, defined and measurable;
- the information is robust and consistent with our guidance on the business plan.

We will work with Scottish Water to ensure that the business plan meets our needs and can be used to inform the price setting process. We will require Scottish Water to publish at least a summary version of the first draft business plan and both a summary and full version of the second draft business plan. The publication of this plan and in particular the detailed investment programme will be important in reassuring customers that they will receive value for money.

Reporters

Successful regulation relies on high-quality information and analysis. This is especially true for the Strategic Review process where we will place high reliance on the accuracy of information provided to us by Scottish Water.
The agreement between this Office, Scottish Water and the Scottish Executive on the ten principles included the introduction of a Reporter.

Principle 4

> *"A Reporter of regulatory information will be appointed as soon as practicable. The Reporter will operate in a fashion similar to Reporters in England and Wales. The Reporter should be appointed by the Commissioner and would be chosen from amongst persons that have served at least three years as an Ofwat-named Reporter. The Executive will meet the cost of the Reporter"*

In England and Wales it is water industry practice for Ofwat to use a consultant engineer (known as a Reporter) to help verify a company's return. The Reporter audits the information provided to the regulator by the company and highlights any issues or inaccuracies. We appointed a Reporter for the water industry in Scotland in December 2003.

The regulatory Reporter is Mr. David Arnell[12] of Black and Veatch Consulting. We will request the Reporter to review all aspects of Scottish Water's information returns. This will include the audit of both Scottish Water's annual regulatory return and its business plan. In particular, we will ask the Reporter to review the proposed investment programme to ensure that Scottish Water's investment plans are robust. Such scrutiny has played an important role in improving the quality and reliability of information provided to Ofwat by the companies in England and Wales.

There were four reasons why we wished to appoint a Reporter.

- There was a need for an independent assessment of the quality and reliability of information provided by Scottish Water.
- We believed that a Reporter could assist in accelerating the improvement in information quality in Scotland.
- We believed that a Reporter could help Scottish Water ensure that proper processes for collecting, storing and using information were established.

[12] Mr Arnell is also the Reporter for Northumbrian Water Services Ltd.

- We believed that a Reporter could assist us in defining 'core' and 'non-core' activities and ensuring that the 'retail'/'wholesale' split was robust.

Conclusion

In the last five years we have established a strong foundation for regulation of the water industry in Scotland. Within this framework, Scottish Water has already reduced its operating costs by some 20% and, by the end of the current Review period, we expect that it will have reduced operating costs by £145 million in real terms. Customers' bills will be some 15% lower than they would otherwise have been as a result.

We recognise that there are lessons that we can learn from the first full Strategic Review of Charges. This information and consultation document is the second in a series of five such publications that will explain our proposed approach to the next Review. Our approach draws on the Better Regulation Task Force principles of transparency, accountability, proportionality, consistency and targeting. We would very much welcome the views of stakeholders on our proposed work plan or approach. These can be sent to:

Katherine Russell
The Water Industry Commissioner for Scotland,
Ochil House
Springkerse Business Park
Stirling
FK7 7XE

or by email to
SRCMethodology@watercommissioner.co.uk

The final date for comments is 29 October 2004.

Section 1: Chapter 1
The importance of regulation to customers

1.1 Introduction

As Water Industry Commissioner for Scotland (WICS), my principal statutory duty is to promote the interests of customers. I promote the interests of customers by encouraging Scottish Water to become more efficient. Scottish Water can become more efficient by reducing the cost of delivering an acceptable level of service or by improving service to customers without increasing its costs.

The Scottish Ministers can ask for my advice on charges when they consider this is necessary. Advice is likely to be required either at the end of the previous price setting period or if new information becomes available about the scale of investment. In order to provide advice on charges to the Scottish Ministers, we undertake a detailed review of the costs incurred by Scottish Water for the provision of water and sewerage services. This review is called the Strategic Review of Charges. The Review provides advice to Scottish Ministers on the minimum revenue that Scottish Water will have to raise in order to properly to deliver the service level required by customers.

The last Strategic Review of Charges covered the period 2002-06. In November 2005 we shall publish our second full Strategic Review of the Scottish water industry.

This Review was commissioned by the Minister for Environment and Rural Development, Ross Finnie, MSP, on 26 May 2004, under Section 33 of the Water Industry (Scotland) Act 2002. The Review will outline the price and revenue implications for customers of Scottish Water for the period 2006-10.

In the next three months we intend to publish a number of consultation documents that will set out our proposed methodology and approach for the Review. All of the documents that we have published, and will publish over the coming months concerning the Review, reflect our intention to provide an open and transparent process. This is in accordance with our commitment to the Better Regulation Task Force principles of proportionality, accountability, consistency, transparency, and targeting.

1.2 Structure

In this document we outline the background to our work in assessing the appropriate level of prices. The document is presented in two sections.

Section I sets out and explains the background of the Review and the current regulatory framework. It explains the context for the Strategic Review of Charges, and includes a review of the approach adopted at the last Strategic Review of Charges.

Section I consists of nine chapters. This first chapter discusses how customer service and economic regulation brings benefits to customers. It also provides a brief history of the Scottish water industry. Chapter 2 reviews the methodology that we adopted to complete the first full Strategic Review of Charges. Chapter 3 summarises the advice that we provided in that Strategic Review and the reasons for our advice. Chapter 4 describes the resource accounting principles that applied to the public expenditure limits set by Ministers for the 2002-06 Strategic Review. Chapter 5 discusses performance monitoring, and Chapter 6 outlines the ‘Ten Principles’, which are written terms of understanding between the Scottish Executive, WICS and Scottish Water. Chapter 7 discusses issues relating to Scottish Water’s access to debt. Chapter 8 describes the Finance Committee’s Inquiry. Finally, in Chapter 9, we highlight some of the lessons that we have learned and how we intend to apply these lessons in the next Strategic Review of Charges.

Section 2 (Chapters 10 to 15) discusses changes to the regulatory framework that are anticipated in the near future and the impacts these changes might have for both customers and regulation.

Chapter 10 outlines the proposal to move from a single regulator with advisory powers to a Commission with powers of determination. Chapter 11 discusses the implications of the amendment to the Water Industry (Scotland) Act 2002, which limited the role of the Commissioner to promoting the interests of customers of the core business. Chapter 12 discusses proposals to introduce retail competition for business customers.

Chapter 13 focuses on proposals to bring trade effluent tariffs within the remit of the economic regulator. Chapters 14 and 15 describe changes to the work that this office carries out in completing the Strategic Review of Charges; Chapter 14 outlines the new requirement upon Scottish Water to provide a detailed business plan outlining its strategy and objectives for the next regulatory period and Chapter 15 describes the role of the Reporter.

Further consultation documents

Later this year, we shall be publishing further documents which will consult stakeholders about particular aspects of the methodology that I will adopt at the next Strategic Review:

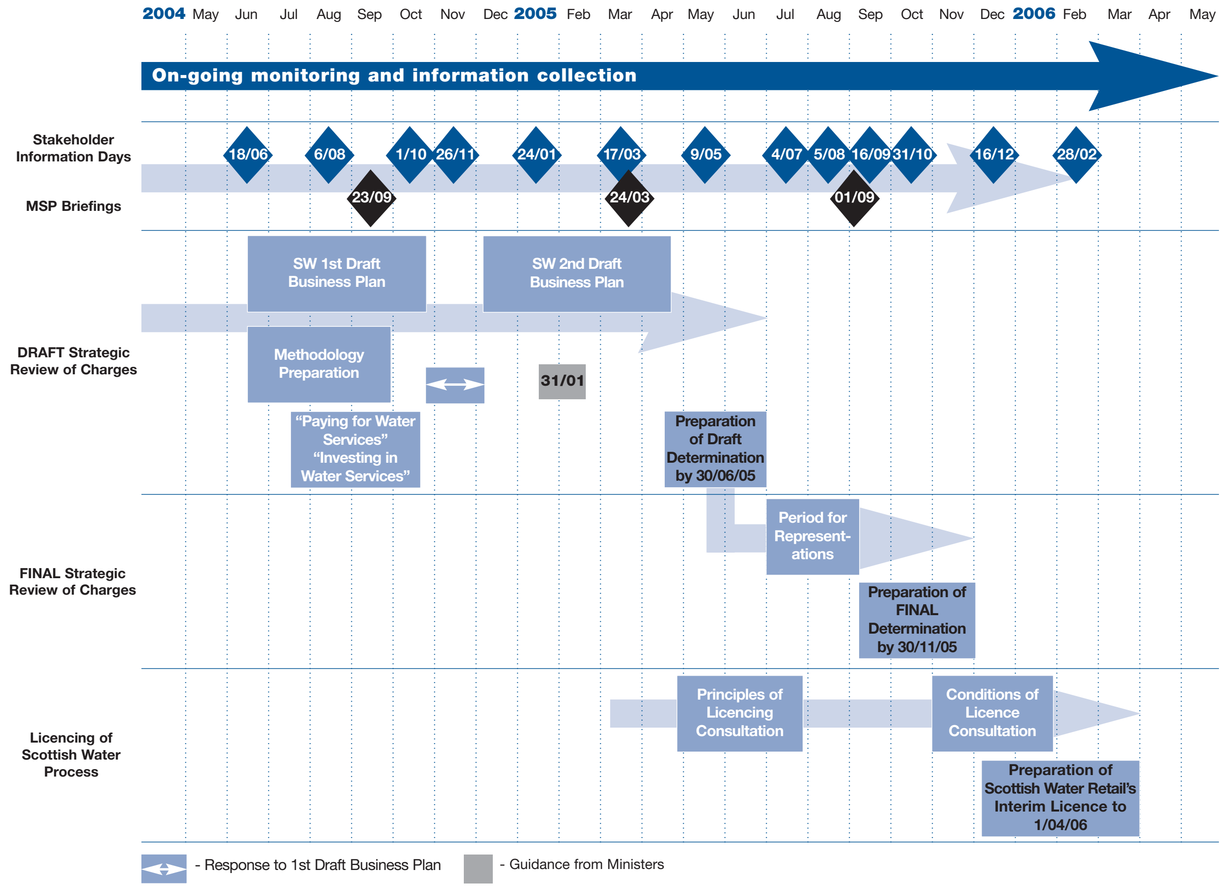
- The methodology for calculating prices consultation document, which will be published **on 22 September 2004**, will cover the way we calculate prices, including issues such as establishing the regulatory capital value and determining an appropriate return on capital.
- The methodology for assessing the scope for efficiency consultation, which we will publish on **29 September 2004**, will examine the scope for efficiency gains in capital costs and operating costs.
- We are also publishing a summary of the methodology consultation on **29 September 2004**.

We will carefully review all responses to the consultation documents, including this framework document. On 19 November 2004 we will publish a formal response, setting out how the issues raised by respondents will be addressed.

We are also planning a series of workshops and stakeholder information days so that interested parties can express their views in person. Details of these events are contained in *Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges* (July 2004), which is available on our website.

The timeline for the current Strategic Review of Charges is illustrated in the figure opposite.

Figure 1: Calendar of events for the next two years



Throughout this document we refer to the regulatory role of this Office but it should be emphasised that the legislative duties of regulating Scottish Water reside with the Water Industry Commissioner as an individual and the Office supports him in this function.

1.3 Customer interest

The post of Water Industry Commissioner for Scotland was created under Part II of the Water Industry Act 1999. Section 12 of the Act states:

> 67A. – (1) There shall be a Water Industry Commissioner for Scotland (in this Part of this Act referred to as the "Commissioner") who shall have the general function of promoting the interests of customers of the new water and sewerage authorities.

The Commissioner achieves this general function through specific functions, also set out in statute. These specific functions are:

- providing advice to Ministers, and
- investigating complaints.

The statutory requirement to provide advice to Ministers covers advice on both the economic performance and the customer service performance of Scottish Water.

On economic performance, Section 33 of the Water Industry (Scotland) Act 2002[1] specifies that the Commissioner must provide advice to Scottish Ministers concerning what should be taken into account by Scottish Water in "fixing charges in charges schemes".

[1] This section replaces Section 13 of the Water Industry Act 1999, which refers to 'the new water and sewerage authorities'

Section 33 also sets out the elements of financial and economic performance that he should take into account in preparing his advice, as:

- the economy, efficiency and effectiveness with which Scottish Water is using its resources in exercising its core functions;
- the likely cost to Scottish Water, for the period of the advice, of exercising its functions;
- the likely resources, other than income from charges for goods and services, available to Scottish Water for the period of the advice;
- any guidance issued to Scottish Water by the Scottish Ministers; and
- any directions given by Scottish Ministers, of a general or specific character, concerning the operation of Scottish Water.

As far as customer service performance is concerned, Section 3 of the Act specifies that the Commissioner is to advise the Scottish Ministers on any matter which appears to me, or to them, to relate to:

- the standard of service provided by Scottish Water to its customers; or
- the manner in which it conducts its relations with its customers or potential or former customers, in the exercise of its core functions.

With respect to the investigation of complaints, Section 3 of the Water Industry (Scotland) Act 2002 specifies that the Commissioner "must investigate any complaint made to the Commissioner or a Customer Panel by a current, potential or former customer of Scottish Water as respects any of its core functions".

Section 3 also empowers the Commissioner to make representations to Scottish Water about any matter to which the complaint relates, or which appears to him to be relevant to the subject matter of the complaint.

1.4 The provision of advice to Ministers

In order to fulfil the statutory requirement to advise Ministers, the Commissioner must undertake the functions of economic and customer service regulator of Scottish Water.

Economic regulation involves undertaking a Strategic Review of Charges, approving Scottish Water's annual scheme of charges, and performing ongoing monitoring of Scottish Water's economic performance.

Customer service regulation involves performing ongoing monitoring of Scottish Water's customer service performance and approving Scottish Water's Code of Practice.

1.4.1 Economic regulation

Economic regulation of Scottish Water involves undertaking a Strategic Review of Charges when directed to undertake such a review by Ministers. The Review determines the level of revenue required by Scottish Water in order to be able to finance the core functions of providing water and sewerage services on a sustainable basis. The cost of the capital investment programme that is decided by Ministers following public consultation is assessed, as is the operating expenditure required for each year of the Review period. The Review takes full account of the efficiencies that Scottish Water can be expected to make.

One of the most important aspects of economic regulation is ongoing monitoring of Scottish Water's economic performance. The Strategic Review of Charges is a baseline against which performance can be measured. Each year, we collect a significant amount of information from Scottish Water. This is information that Scottish Water should already use to manage its business effectively. We carry out analysis of the financial and economic information that we receive and use this to monitor and report on performance in two reports (the Investment and Asset Management Report and the Costs and Performance Report).

As economic regulator, the Commissioner is also responsible for approving Scottish Water's annual scheme of charges. Each year, Scottish Water produces a proposal for charge levels for the following year. This Office analyses the proposals then decides whether or not it can approve them. The Commissioner first has to ensure that the Scheme of Charges is fully consistent with the advice that was approved by Ministers. Second, given that the role of the Commissioner is to promote the interests of all customers, he must ensure that charges are broadly cost reflective and that there are no unintended cross-subsidies between customers. Any changes from one year to the next in the burden of charges between customer groups must be backed by a clear cost justification.

If the Commissioner considers that the scheme is not consistent with the advice approved by Ministers, and Scottish Water does not agree to the modifications proposed, under section 3 of 2002 Act he must send the scheme (with any proposed modifications) to the Scottish Ministers. Scottish Ministers are then responsible for approving the scheme with any modifications they see fit to make.

1.4.2 Customer service regulation

Customer service regulation of Scottish Water involves ongoing monitoring of Scottish Water's performance on customer service measures. Once again, this is achieved through review, analysis and reporting of submissions of customer service information from Scottish Water. We can also make use of information from our investigation of complaints (see below) and from our programme of consultation.

We work with the Water Customer Consultation Panels (WCCPs) to ensure that Scottish Water offers an appropriate level of service to customers. The WCCPs have a remit to represent customers and can make representations to the Commissioner.

An important aspect of customer service regulation is the approval of Scottish Water's Code of Practice. Scottish Water has an obligation to produce a Code of Practice under section 26 of the Water Industry (Scotland) Act 2002. The Code of Practice provides information on the standards of service that customers can expect and on how Scottish Water will deal with customers.

Once Scottish Water has prepared a draft of its Code of Practice, it will submit this to the Water Industry Commissioner. The Commissioner will consult with the WCCPs and compare the proposed service levels with those offered by other water and utility companies. Comments and suggestions are provided to Scottish Water and new drafts are reviewed until a final version is agreed.

1.4.3 Investigating complaints

In order to fulfil the statutory requirement to investigate complaints, we investigate written or telephone complaints that we receive direct from customers, as well as complaints referred to the Commissioner by the Convenor of the WCCPs.

In some cases the complaint may be dealt with by providing an explanation to the customer about how a decision has been reached or by confirming that Scottish Water has carried out an appropriate process or procedure. In other cases we may have to intervene in order to help resolve a dispute between Scottish Water and the customer, or may have to provide Scottish Water with a recommended course of action.

1.4.4 The Commissioner's statutory powers

The Water Industry (Scotland) Act 2002 gives the Commissioner very wide powers in order to carry out his functions. Section 3 states:

> (7) The Commissioner has the power to do anything which is calculated to facilitate, or is incidental or conducive to, the exercise of the Commissioner's functions.

The Act also gives statutory recognition of the importance of information to effective regulation.

Section 4 of the Act gives me the power to require information from Scottish Water:

> (1) Scottish Water must, on being requested to do so by the Commissioner, provide the Commissioner with such information held by it as the Commissioner may reasonably seek in the exercise of the Commissioner's functions.
>
> (2) Where Scottish Water and the Commissioner cannot agree as to whether information is sought reasonably, either of them may refer the matter to the Scottish Ministers, whose decision is final.

1.4.5 How the Commissioner’s role has developed

Since this Office was created in 1999, the scope of our activities has broadened. In our first years of operation we concentrated on the first Strategic Review of Charges and on collecting the information that was essential to that Review. Gradually our ongoing monitoring of Scottish Water has taken on greater importance.

Proposals under the Water Services (Scotland) Bill will see the role of this Office develop further. The Bill proposes the introduction of retail competition for non-domestic customers. We would take on the role of licensing authority and would have a part to play in policing competition in the new market.

1.5 Economic regulation

1.5.1 Why is economic regulation needed?

The purpose of regulation is to seek to ensure that monopoly businesses act in the customer interest. Customers should not have to pay higher prices or accept lower levels of service because they are unable to choose their supplier.

Monopolies can exist in both the public and private sectors. They can also exist at an international, national or local level. In theory a monopoly exists when there is a single supplier to a defined market. In practice there are very few examples of such pure monopolies. An effective monopoly is present when most, if not all, customers do not have any real choice and when the dominant market supplier determines the terms and price of supply. The limited options that exist for customers to make water or waste water arrangements separate from the public network do not substantially alter the extent of Scottish Water’s monopoly. Similarly, in England and Wales, although a customer in one area can request a service from a supplier in an adjoining area, in most cases this is not economically viable.

Network utility industries tend to be monopolies because the cost to replicate the network would be excessive. Economists describe them as involving a significant ‘natural monopoly’ element. A ‘natural monopoly’ refers to the situation where there is only one firm supplying a product in the market, but this is not the result of the firm’s behaviour. Instead, it arises as it is the sensible way to organise the industry and it is in the best interests of customers to do so.

The reason that it is sensible to organise the industry in this way is that it is cheaper for one firm to supply the whole of the market than for two or more firms to share the market. For example, a single firm may have costs of £2 million to supply the whole market, whereas if two firms shared the market each firm may have costs of £1.5 million. It follows that if there were a single firm in the market customers would have to pay £2 million in charges to cover costs whereas if there were two firms in the market customers would have to pay £3 million in charges. In such a situation the single firm is benefiting from economies of scale.

However, the behaviour even of natural monopolies may work against the customer interest if unchecked. There are two ways in which this might happen.

First, if the service is essential and the customer has no choice about where to purchase it, the monopoly has an incentive to charge an excessive price and to make excessive profits. This type of behaviour is known as monopoly pricing. Because the product is essential the firm can raise its price without demand for the product falling too far. The firm's profits will therefore increase as it raises its price. From the customer's point of view there is little alternative to buying the product regardless of the price. Water and power are typical products of this type.

Second, in the absence of competition the monopoly faces no incentive to innovate and improve its efficiency over time. From the point of view of the firm a failure to innovate and improve efficiency will have little or no implication for the size of the market that it serves or the level of profit that it earns. Compared with a competitive market, the industry will tend to stagnate.

1.5.2 What does economic regulation do?

In the private sector, the regulator will seek to establish a balance between customers and the providers of finance. In doing so, it is the regulator's duty to ensure that an efficient business can fund its operations. It is important to customers that the service is provided on a sustainable basis. It is left to the owners of the privatised business to ensure that management meets or exceeds the targets set by the regulator. Such outperformance is the only way to ensure that the owners of the business will receive a higher return on their investment.

In the public sector, regulation of the water industry focuses on ensuring that customers receive a value for money service that delivers the environmental and public health objectives of the Government. These objectives apply over the short, medium and long term.

In both the public and private sector, economic regulators seek to establish a tight budgetary constraint on the regulated body. In other words, clear statements are made about the outcomes for customers that the body must deliver and about the amount of money that can be spent. This can be achieved by fixing the maximum return available (unless targets are beaten) or by limiting the total cash funds that may be consumed.

This tight budgetary constraint should focus management attention on delivering on-going improvements in value for money to customers. This explains why regulators publish regular assessments of the financial performance of the companies or organisations they regulate. Of course, regulators will also monitor the outcomes for customers very carefully. It is not in the customer interest that budgetary pressures result in corners being cut either in customer service or in the way the asset base is maintained. In this regard it is important to be clear about what regulators mean by efficiency: we recognise efficiency when an improved or at least equivalent level of service has been delivered to customers at a lower cost.

In a competitive market, companies face similar tight budgetary constraints in that they have to match their costs to the revenue they can win from customers. Regulation consequently provides a proxy for the discipline of competition.

The annual process of approving Scottish Water's scheme of charges is a central part of providing this discipline in the Scottish water and sewerage industry. In the approval process the revenues that would be generated by Scottish Water's proposed charges are compared with the revenues that are allowed by the Strategic Review of Charges limits. The Strategic Review of Charges limits, or revenue caps, represent the revenue that an efficiently run Scottish Water would require in order to provide water and sewerage services. If the charges proposed by Scottish Water were to generate more revenue than is allowed by the Strategic Review of Charges revenue cap, this would indicate monopoly pricing. The regulatory process ensures that Scottish Water's charges are consistent with the revenue cap and so do not contain a monopoly pricing element.

Regulation can also provide an incentive for efficiency and innovation. While the Strategic Review of Charges sets targets for capital and operating cost efficiency, ongoing monitoring of Scottish Water's performance on managing assets and improving efficiency ensures that there is continuous pressure on Scottish Water to meet these targets.

Finally, regulation can provide a framework that encourages investment. The water and sewerage industry is an asset-intensive industry that relies on expensive assets with very long lives. If the industry is to provide a reliable service, at the level of quality that is expected by customers, it is important that regulation should provide incentives to invest and should avoid producing disincentives to invest. Regulation can achieve these objectives if the regulator can provide a commitment to the regulated firm that once the investment has been made the firm will be allowed to recover the cost of that investment, including a fair return on capital.

The regulatory process should also avoid any bias in the treatment of operating and capital costs so that there is no distortion in the choice between capital investment and operating solutions.

1.5.3 What are the limits to economic regulation?

As discussed, the purpose of regulation is to seek to ensure that monopoly businesses act in the customer interest. Regulation seeks to capture the benefits of economies of scale enjoyed by a natural monopoly and to avoid the excessively high prices and the tendency to stagnate that characterise unconstrained monopolies. However, there are limits to the ability of regulation to perform this role.

The effectiveness of regulation will depend on the quantity and accuracy of information available to the regulator and the consistency and clarity of the policy framework within which he operates.

In common with other economic regulators, we collect a large amount of information from Scottish Water. This information is collected in standard formats. Each request for information is issued with a clear explanation and detailed definitions of what is required. Recently, we agreed with the Scottish Executive and Scottish Water that we should appoint a Reporter to audit the consistency and completeness of information provided to us. This brings the Scottish industry broadly into line with the situation south of the border.

Regulators can also benefit from other information sources, but the information provided by the regulated company will always be the most important. Unfortunately, the regulated company can try to use its control of information to its advantage. Such an attempt can create an information asymmetry and may, in the short to medium term, reduce the effectiveness of regulation. Over the longer term, there are measures that a regulator can take to compensate for such behaviour. We believe that the information process that we have established has reduced this potential risk to customers.

Regulation of network industries takes place within a complex policy framework. It is important that the regulator has the benefit of clear guidance in order to be able to strike an appropriate balance between potentially competing priorities (low bills or additional environmental improvements).

In the water industry, the Office of Water Services (Ofwat) initiated a system of comparative competition to improve the value for money received by customers. All of the regulated water companies have an incentive to invest because they are guaranteed a return on efficient investment and are allowed to keep the benefits of outperformance of regulatory targets for five years. Comparative competition ensures that the performance of each company (in terms both of costs and levels of service) relative to its peers is clear. This performance is reflected in Ofwat’s performance monitoring assessments, for example, through publication of ‘league tables’. Unless a company is content to see itself at the bottom of the performance league, it has an incentive to innovate and improve its performance. This regulatory regime does mimic a genuinely competitive market.

1.6 Customer service regulation

1.6.1 Why is customer service regulation needed?

Scottish Water’s customers are concerned not only about the price that they pay for water and sewerage services, but also about the quality of service they receive. It is the combination of these two elements that determines whether customers receive value for money from Scottish Water.

There are many different aspects of Scottish Water's quality of service. Some of these relate to the operation of the network; for example, how frequently supply is interrupted and the quality of the water delivered. Others relate to the interaction between Scottish Water and its customers; for example, the time taken to respond to billing enquiries or the time taken to respond to a complaint. Regulation must take account of all aspects of quality of service.

In a competitive market, firms compete with each other in terms of price and quality. However, competition in terms of quality is not straightforward, as customers do not always demand the highest level of quality that is possible. In some markets firms occupy niches, so that customers have the choice of products or services that are low cost and low quality, average cost and average quality, high cost and high quality, and so on. Customers with different preferences will chose the cost-quality combinations that match their preferences. However, for any given level of cost, the competitive firm has an incentive to ensure that the good or service is provided with the highest possible level of quality.

In a regulated market, just as the incentive to reduce costs has to be provided by the regulatory framework, so too must the incentive to provide the highest level of quality possible for any given level of cost.

Where prices are regulated the company may have an incentive to meet cost reduction targets by reducing quality. For example, in order to meet operating cost targets a water company could reduce maintenance activity and allow the network to deteriorate. Alternatively, it could reduce the capacity for handling billing contacts or other enquiries and allow performance in these areas to worsen. Although the cost reduction target may be met this does not constitute an improvement in efficiency. As previously outlined, improved efficiency implies either a higher quality output for the same price or the same quality output for a lower price.

1.6.2 What does customer service regulation do?

Regulation can provide an incentive for the regulated firm to improve the quality of the service it provides.

It can do this directly by setting targets for different elements of service quality and measuring performance against those targets. However, the regulator would require a considerable amount of information in order to set targets for each element of service quality. The regulator would also require information about the level of service quality that is possible for any particular level of cost, and about customer priorities between the different aspects of customer service. This is because for a given level of cost, a higher target for one aspect of customer service may mean lower targets for other aspects of customer service.

Rather than setting targets for each aspect of service quality, the regulator in Scotland and England and Wales, may compare actual performance against other similar companies ('comparative competition'), and highlight areas where performance could be improved. The regulator may then monitor performance and report on how well the company is performing against the areas identified for improvement.

1.6.3 What are the limits to customer service regulation?

Effective customer service regulation is dependent on good quality information on customer service performance. Reliable information about the quality of customer service is more difficult to collect than information about costs, customers or assets. Much of the information relies on works management reporting, statistical analyses and complaints. Moreover, performance in individual years may be adversely impacted by abnormal events.

In Scotland we do not yet have an accurate picture of the quality of service performance and how it compares with performance south of the border. In England and Wales, information about the level of service to customers has been collected for a number of years. Regulation by comparative competition and audit of information by Reporters has ensured that this information now accurately reflects the service provided to customers. By contrast, in Scotland we have only relatively recently begun to collect information about the level of service to customers in a consistent way. Over the next few years, we would expect this information to become much more reliable so that more detailed comparisons with levels of service south of the border will be possible.

1.7 A brief history of Scottish Water

Part II of the Local Government etc (Scotland) Act 1994 created three water authorities – East of Scotland Water Authority, North of Scotland Water Authority, and West of Scotland Water Authority.

Before the water authorities were created, the nine mainland regions and three island areas of local government provided water and sewerage services. Historically there has been a trend towards concentration in the water and sewerage industry, prompted by advances in engineering and more demanding standards for customer service and the environment. In 1945 there were 210 water authorities in Scotland, and even as recently as 1973 there were 234 separate sewerage authorities.

By moving to three providers, significant economies of scale became possible for large areas of the country. Scotland was divided into three areas of provision, largely reflecting the existing supply and disposal networks, and the boundaries of previous local authorities:

- East of Scotland Water Authority served the former Lothian, Borders, Fife, and Central Regional Councils. The authority also took on responsibility for the Kinross area of Tayside and the services provided by the Central Scotland Water Development Board.
- North of Scotland Water Authority served the former Highland, Grampian and Tayside Regions (excluding Kinross) and the Island Councils of Orkney, Shetland and the Western Isles.
- West of Scotland Water Authority served the former Dumfries & Galloway and Strathclyde Regional Council Areas.

The same Act established the Scottish Water and Sewerage Customers Council, which, as predecessor to this Office, had the function of “representing the interests of customers and potential or former customers of the new water and sewerage authorities”.

The three authorities and the Secretary of State jointly had a duty to have regard to the interests of customers and potential customers. Each authority was also under a statutory obligation to draft a Code of Practice to make provision as to:

- standards of performance in providing services to customers;
- procedures for dealing with customer complaints; and
- the circumstances in which they would pay compensation if standards were not attained.

The three authorities had the power to set a charges scheme subject to approval by the Customers Council.

1.7.1 Merger of the three authorities

In our interim *Strategic Review of Charges 2002-06*, published in November 2001, we identified that the level of investment in maintaining the water and sewerage infrastructure needed to be significantly increased. Sarah Boyack, the then Minister for Transport and the Environment, accepted the principle that there was a need for increased investment, but suggested that more work was necessary to identify the scope and extent of the investment required. She therefore did not implement the full price increases that had been recommended. Nonetheless, the 43% increase in prices to households in the north of Scotland was very unpopular – especially as the increases in the Central Belt were less than 20%.

Early in the *Quality and Standards II* process, it became clear that investment requirements in the north of

Scotland would lead to further significant price increases in the *Strategic Review of Charges 2002-06*. We encouraged the three authorities to work together to establish whether there could be savings from joint working. This project confirmed that there were significant potential savings and that a merger was likely to be the best way to realise these savings quickly.

In late 2000 and early 2001 the Transport & Environment Committee held an enquiry into the water industry. This enquiry heard evidence from many stakeholders about the impact of prices in the north. It also heard evidence that there was significant scope for efficiency. Members of the Committee began to ask whether a merger of the three authorities could bring benefits to all customers. At his evidence to the Committee on 28 February 2001, Mr Sam Galbraith, Minister for Environment, Sport and Culture, announced that he had become convinced that a merger was in the interests of all customers. He said that he had decided to merge the authorities because of the potential for cost savings. He explained that this would allow future charge increases to be kept as low as possible, and would place the industry in a better position in the event that competition was introduced.

1.7.2 Harmonisation of Charges

The Transport & Environment Committee also accepted that charges should be harmonised throughout Scotland. The Scottish Executive decided that the same type of customer should pay the same charge regardless of where they lived or worked in Scotland. This was seen to be a matter of fairness between customers and would be consistent with pricing for other utility and postal services.

Maureen Macmillan (MSP, Highlands and Islands) (Lab), a member of the Transport and Environment Committee, asked the following question:

> **Maureen Macmillan (Highlands and Islands) (Lab):** I am happy to hear the Minister's commitment to a single authority, which will be of great benefit to the north. What time scale do you envisage for that? The North of Scotland Water Authority has said that, in the next couple of years, consumers in its area will pay the highest charges in the UK. Could a single tariff be introduced in advance of merging the three authorities?
>
> **Mr Galbraith:** I hope that we can introduce that as soon as possible, but the time scale depends on the parliamentary process. We cannot introduce anything before that is followed through. It is fair to say that the prices and some of the large increases are reaching their peak and should begin to level off. The future is brighter.
>
> Maureen Macmillan is correct to point out an interesting epiphenomenon of moving to one authority, which will be assistance. However, that is not the reason for the change. The reason is to become more efficient, to retain the service in the public sector and to allow it to stand up to competition. We will introduce a single tariff as soon as possible, commensurate with the parliamentary process.

The three separate authorities remained in existence until the formation of Scottish Water under the Water Industry (Scotland) Act 2002. Under sections 21-23 of the Act the functions, property, liabilities, and staff of the water and sewerage authorities were transferred to Scottish Water.

Scottish Water remains in the public sector, and is owned by and accountable to the Scottish Executive and Ministers. However, the structure and management of Scottish Water draws on the private company model. Scottish Water has 12 board members, comprising 5 executive directors and 7 non-executive directors. The combination of public sector ownership and private sector organisational structure should ensure that the business is run in the public interest as efficiently as possible.

The 2002 Act gives Scottish Water wide powers to engage in any activity to which it considers necessary or expedient for the purposes of carrying out its core functions. Scottish Water was also required to agree a

Consultation Code with the WCCPs and to provide this to Scottish Ministers.

The process of harmonising charges for non-domestic customers began in April 2002. In this first stage, Scottish Water made a number of incremental changes intended to bring the charges used by the previous water authorities more into line with each other; for example, fixed charges for customers formerly served by North of Scotland Water Authority and West of Scotland Water Authority were increased considerably. This moved their charges towards the structure employed for metered customers by East of Scotland Water Authority.

In April 2003, however, all non-domestic charges moved to a single structure, with all remaining harmonisation being carried out in a single step. Harmonised charges across Scotland mean that customers pay a similar amount for a similar service. Thus, a business with water and wastewater services in Inverness should pay the same as a business with similar water and wastewater services in Dumfries.

Scottish Water has completed two years in its new form and has made good progress in reducing its operating costs. To date progress in the delivery of the capital programme is still limited. Customers will truly benefit when progress in improving the efficiency and delivery of the capital programme accelerates.

1.8 Regulation in the public sector

There is a clear consensus that water should remain in the public sector in Scotland. The role of regulation is to set a framework within which Scottish Water can improve its efficiency and consequently the value for money it provides to customers.

If a public sector organisation can match the level of efficiency of investment and service delivery that is achieved by the private sector, customers of that public sector supplier could expect sustainably lower prices than could ever be achieved by the private sector. This is because the public sector is consistently able to access a lower cost of capital. There can be no doubt that Scottish Water's customers benefit significantly from access to attractive terms for public government loans that are much cheaper than the private sector's cost of capital. These government loans attract interest rates that are lower than the cost of commercial debt of similar term length for a water and sewerage company in England and Wales. Moreover, such relatively expensive private debt is considerably cheaper than equity. Although direct comparisons can be difficult because of the existence of equity and the duration, base rate and tax issues associated with private debt, a comparison with Ofwat's allowed cost of capital helps to illustrate this point.

Ofwat's allowed cost of capital for the period 2000-05 (which assumed a 50-50 split between debt and equity), is 4.75% post-tax for the water and sewerage companies. Government loans to Scottish Water since April 2002 attracted interest rates of between 3.3% and 4.9%. The weighted average interest rate for new loans taken out by Scottish Water in 2002-03 was 4.08%. This would be equivalent to 2.86% post-tax.

We estimate that Scottish Water's customers probably benefit by around £44 million per year, because of this 2% saving on the annual cost of capital. We have calculated this on the basis of current total borrowing of approximately £2.2 billion.

It is important to note that this cost benefit will only truly be realised by customers if they are not exposed to operational risks and if the service is delivered efficiently.

However, as regulator we must take into account that customers of Scottish Water are more immediately exposed to the financial risks of the business than customers in England and Wales. This is because there are no private equity shareholders. In the event of an external shock or underperformance by the business a private utility can:

a) withhold dividend payments to shareholders;

b) seek a rights issue; and

c) obtain debt in the private markets.

Scottish Water, by contrast, must either:

a) seek unplanned public expenditure in the form of a loan, or

b) increase charges to customers immediately.

The presence of private equity acts as a significant shock absorber, so protecting customers in England and Wales. An example to illustrate this point is the costs that resulted from the drought in 1995 (approximately £250 million), which had to be absorbed by the equity holders of Yorkshire Water. Moreover, the regulator cut the prices that could be charged to customers, as a result of poorer service, and consequently further limited the return available to shareholders.

The private sector provides a further level of risk management that benefits customers. Strong incentives help to reduce the exposure of customers to financial risk. The commercial interests of the company are served by ensuring that management takes action to minimise the impact of external shocks on the business. Even more importantly, there are commercial incentives to outperform efficiency targets, which benefit customers in the medium term[4]. The tight budgetary constraints apply a degree of financial discipline to the business, so that there are 'sticks' as well as 'carrots'.

However, we should emphasise that it is not necessary to adopt an equity-funded model in order to manage financial risk. Glas Cymru[5] has established a structure that protects customers from financial risk, without a traditional shareholder acting as a 'shock absorber' since total debt is less than its regulatory asset value.

Glas Cymru purchased the assets of Welsh Water for 95% of its regulatory capital value. This lower purchase price, a clear ring-fence on activities, and the transparent incentives that are published in advance have all contributed to a lower cost of capital. Glas Cymru is believed to have one of the lowest costs of capital in the water industry south of the border. This results from its focus on the core business and the way it does not use equity capital. Its average cost of debt is approximately 6.8%. This is equivalent to 4.76% post-tax. The actual post-tax cost of capital for Glas Cymru is under 4.5% because the assets were purchased below their regulatory asset value. The budgetary constraints are still tight and the debt provided by private banks is at risk if there is an unforeseen shock. However, customers are protected because the banks are committed in advance to making additional funds available if there is such a shock – although there is likely to be governance implications for the organisation. Customers would not suffer (assuming that proper management could have avoided or limited the shock) since Ofwat would be under no obligation to increase the cash value of the return on capital allowed to Welsh Water as a consequence of any unforeseen shock.

At the current time, the regulator can attempt to limit the risk to customers by adopting prudent financial ratios and consequently a margin between the public expenditure used and the maximum made available. Nonetheless, customers are exposed directly to external shocks. They are particularly exposed to any shortfall in Scottish Water's performance against targets. If Scottish Water underperforms, and borrows more, this will raise prices for future customers. Extra borrowing leads to extra interest payments and consequently higher prices for customers.

As we outlined above, regulation can only be fully effective if there is a transparent, tight budgetary constraint on Scottish Water. The level of improvement in efficiency that is necessary to improve value for money to customers will only be possible with such a constraint. It would be reasonable for this constraint to have two levels – a maximum published in advance that would apply in all reasonably foreseen situations and a contingency that would only be triggered in genuinely exceptional circumstances. Our current understanding is that the current funding arrangements that the Scottish Executive has in place for the remainder of this regulatory period are consistent with these recommendations. As with Glas Cymru, however, the consequences of such exceptional circumstances should not have an impact on the price paid by customers.

[4] Outperformance in a regulatory period can be retained by the company for five years. This benefit is then transferred to customers.
[5] Glas Cymru, a not-for profit company limited by Guarantee, acquired Welsh Water in May 2001.

1.8.1 Policy framework

The policy framework is informed by the guidance that we receive from Ministers. In the first years of regulation the main priorities have been improved financial sustainability; greater fairness between customers; and showing that a public sector model for the industry can work.

1.8.2. Financial sustainability

If customers are to benefit from a sustainable industry, we must ensure that we invest appropriately in water services. This means that a generation should pay the full costs of the service that it receives and should not store up problems for the future. Debt can play a key role in funding long-term needs. Borrowing is appropriate to even out the peaks and troughs in investment needs, and to finance genuine one-off investment. Borrowing is inappropriate where there is no realistic prospect of repayment, either because of continuing need for investment, or because of a lack of cash to pay the interest on the loans taken out.

The costs of providing the service can be broken down into operational costs (the costs of running the system), the capital costs (the maintenance, replacement and upgrading of the assets) and the financial costs (the costs associated with debts and funding working capital). Funding the costs of maintaining the system ultimately has to come from customers. If money is borrowed, the costs of these borrowings have to be met by customers both in the present and in the future. If Government provides a grant to the water services provider, the money for this grant also comes ultimately from the taxes paid by customers. Either taxes would have to be increased to meet this cost, or funding for other central Government services would have to be reduced. The customer interest is therefore clear: it is that the costs of service should be reduced to the minimum that is consistent with maintaining a secure, safe and sustainable water and sewerage service.

1.8.3 Fairness

In promoting the customer interest, we must ensure that Scottish Water's charging is fair to all customers. There are a number of ways in which fairness can be interpreted:

- The same type of customer should pay the same charge regardless of where they happen to live. This view of fairness led to the recommendation at the last Strategic Review of Charges that non-domestic charges should be harmonised for all of Scottish Water's non-domestic customers.

- The burden of Scottish Water's costs should be shared fairly between different customer groups. This issue of what would be 'fair shares' of costs between customer groups will be considered in the Scottish Executive's consultation 'Paying for Water Services'.

- Scottish Water should improve its efficiency significantly. Typically, customers in Scotland pay more for the water and sewerage services they receive than they would as customers in England and Wales. It is fair that they should receive an equivalent service for an equivalent price. In other words, customers of Scottish Water should receive value for money equivalent to that received by customers of the companies south of the border. The principle that there was no reason why Scottish customers in general should be asked to pay more than those south of the border underpinned the efficiency targets that we set in the Strategic Review of Charges 2002-06.

1.8.4 Scottish Water to remain in the public sector

The Scottish Executive has no plans to take Scottish Water out of the public sector. It recognises that the best way to justify the public sector model is to improve the efficiency of the water industry in Scotland and to deliver the same environmental and water quality improvements that have been achieved south of the border.

In the 2002-06 Strategic Review of Charges, we set challenging but achievable efficiency targets for Scottish Water's operating and capital costs. We continue to monitor progress towards those targets and believe that significant improvement would justify the public sector model. Such improvement will need to continue into the next regulatory period as there is still a significant efficiency gap between Scottish water and the industry south of the border.

Lessons have been learned from the first full regulatory period. These are described in Section 1, Chapter 9. Section 2 outlines proposed changes to the framework of the industry in Scotland and describe why we believe these to be in the interests of customers. These changes should also help deliver an improved public sector model for the water industry in Scotland.

Section 1: Chapter 2
Review of the methodology for the Strategic Review of Charges 2002-06

2.1 Introduction

In August 2001, our office was commissioned to carry out the *Strategic Review of Charges 2002-06* by the Minister for Environment and Rural Development, Ross Finnie, MP. At that time, the Parliament was considering proposals from the Scottish Executive to merge the three water authorities and create Scottish Water. We therefore had to advise on revenue caps both for the proposed Scottish Water and for the existing three authorities. Our methodology would have to support both potential outcomes and allow stakeholders to make objective comparisons of the implications for customers of the merger.

This chapter reviews the methodology for our *Strategic Review of Charges 2002-06*[1]. The methodology covered:

- the collection and use of information;
- the level of investment;
- the views of customers and the level of service;
- the potential for competition;
- the opportunity for efficiency;
- the calculation of a revenue requirement; and
- the application of a risk analysis to the proposed revenue caps.

We will review each of these areas in turn and will outline:

- the position in 2001 when we developed our methodology;
- the approach we used in 2001; and
- developments since then.

The methodology for the 2006-10 Strategic Review of Charges will build on the solid foundation created by our work in 2001. We will use the improved information that is now available to broaden and deepen the analysis that we were able to complete at that time. In general, however, we believe that the approach that we used remains valid and would still be fit for purpose. There will, however, be several changes in our methodology for the *Strategic Review of Charges 2006-10*. These changes reflect both the lessons we have learned since the last Review and the proposed changes to the institutional framework in the industry. We examine the lessons learned in Chapter 9, and changes to the framework are discussed in Section 2.

2.2 The collection and use of information

2.2.1 The position before 2001

The post of Water Industry Commissioner for Scotland was established in November 1999. At that time there was no structured approach to the collection of information about the performance of the water industry in Scotland. There were clear differences between the three authorities in terms of how they reported the quality of their assets and what they counted as a complaint. In the interim Strategic Review of Charges, we had difficulty in collecting information from the three authorities on a consistent basis. We therefore advised the Minister that we needed to work with the industry in Scotland to agree our information requirements. It was clear that these requirements would need to be carefully defined if we were to ensure that the information provided by each of the three authorities was consistent.

This initiative led to the information project. The project was let to a consortium of Cap Gemini, Ernst & Young, WS Atkins and Yorkshire Electricity. The project focused on creating a Scottish version of Ofwat's June Return. The Scottish version of the June Return is a comprehensive set of financial, physical and performance indicators. It mainly focuses on information relating to the previous financial year, although in some cases it also seeks forward projections. Each line of

[1] For a detailed discussion of the methodology used in 2001, see pages 47 to 104 of the *Strategic Review of Charges 2002-06*.

information requested has a precise and documented definition. We issue these definitions to the industry prior to the submission. The full Annual Return consists of 12 separate sections and comprises 97 tables with more than 20,000 items of both input and calculated data cells.

One of the important strengths of this Annual Return is that it allows us to make robust comparisons with the industry in England and Wales. However, the Scottish version of the Annual Return has to reflect some of the differences in the structure of the industry north of the border. For example, we need to collect information about the Public Private Partnership contracts and about the very many small waste water treatment plants operated by the industry in Scotland.

2.2.2 The approach that we used in 2001

In trial runs of the Annual Return submissions, the three water authorities, understandably, found that it was quite difficult to supply all of the information that was requested. We arranged a series of workshops and worked with the authorities to improve the completeness and quality of the information supplied. Additionally, we asked the authorities to address any gaps in information through Action Plans; these plans set out how the authority intended to complete missing information. The Action Plans spanned a period of four years; some were short term (before April 2001) while others were longer term, lasting up to April 2005.

The *Strategic Review of Charges 2002-06* was based on information supplied in the Annual Returns provided by each of the three authorities in the summer of 2001. This information related principally to the financial year 2000-01. While the authorities still found some of the information quite challenging to provide, the quality and completeness of the information supplied had improved markedly from the initial trial runs.

The Annual Return is the principal information request that this Office makes to the industry. However this Return did not provide all of the information required to complete the Strategic Review of Charges. We used WIC letters to ask for further information about specific issues, including:

- new operating costs resulting from the capital programme;
- spend to save initiatives;
- information about agreements with large customers;
- information about depots, laboratories and office buildings; and
- customer service costs.

We also gained information from customers (this is discussed in greater detail below). The Office also drew extensively on the experience of Ofwat, other utility regulators and third party information sources. These sources were documented in Appendix G of the 2002-06 Review.

2.2.3 Developments since 2001

By the time this Office reaches its final conclusions on the appropriate price levels for the period 2006-10, we will have Annual Return information for five years. The quality of Annual Return information continues to improve.

We began to publish most of the Annual Return in 2003. We expect to publish the entire Annual Return this year. This year will also be the first time that an independent Reporter will scrutinise the information and comment on its accuracy and completeness.

We continue to use WIC letters to collect additional information in a targeted way. The quality and completeness of information supplied in response to these letters also continues to improve.

While we expect that the quality and completeness of information will continue to improve in the next few years, it is clear that the *Strategic Review of Charges 2006-10* will benefit significantly from the foundation that was laid in 2001.

2.3 The level of investment

2.3.1 The position before 2001

Prior to 1999, there was no coordinated approach to the assessment of the investment needs of the water and sewerage industry in Scotland. In November 1999, the Scottish Executive published the *Quality and Standards I* document. This publication outlined the various environmental and public health standards that the industry was expected to meet. It also provided aggregate costs for each investment driver for the period 2000-2002. During 2000, work began on *Quality and Standards II*. This involved each of the three water authorities, this Office, the Scottish Environment Protection Agency (SEPA) and the Scottish Executive. The aim was to identify, at a project level, all the investment that was necessary to comply with environmental legislation and public health standards.

Following the Minister's response to our interim Strategic Review of Charges in 1999 we also worked with the three authorities and the Scottish Executive on an initiative to improve capital maintenance planning within the framework of the *Quality and Standards II* process. There is a clear risk that the desired environmental and public health standards may not be met if the industry does not maintain its assets appropriately. This initiative aimed to ensure that underground assets such as water mains and sewers were repaired, refurbished or replaced in such a way as to maintain the level of service to customers for the foreseeable future.

2.3.2 The approach that we used in 2001

The Scottish Executive launched a consultation document at the end of 2000, inviting stakeholder views on the priorities for investment. The consultation presented three options and provided an indication of how each would affect an average domestic bill. The consultation also sought the views of stakeholders in the following areas:

- whether the same standards should apply throughout Scotland;
- at what speed the underground infrastructure should be improved; and
- at what speed development constraints should be removed and first time connections to the water and sewerage system in rural areas allowed.

The consultation concluded that the middle option should be chosen, but that there should be some additional investment to allow first time connections to the network in rural areas.

We worked with the three authorities to define the projects that were required to meet the priorities that had been established by the consultation. Detailed responses were received from the West and North of Scotland Water Authorities. We received information from the East of Scotland Authority that was sufficient for the cost of the investment to be calculated, but we noted that more work would be required to define the exact projects that would be completed. This information allowed us to begin to consider the optimum phasing of the investment programme. This phasing took account of all deadlines, capital efficiency targets, public expenditure limits and customers' preference for a smooth price profile. We also responded to the concerns of the contracting industry that there should not be large swings in the volume of work available.

2.3.3 Developments since 2001

Although *Quality and Standards II* was the most clearly defined investment programme in the Scottish water industry's recent history, we encountered two difficulties in finalising the detailed list of projects such that we could monitor the delivery and efficiency of the investment programme. The primary difficulty was the lack of specific project detail in the information provided by the East of Scotland Water Authority. The second related to the differences in method used by the three former authorities in defining their investment needs. These difficulties have only recently been resolved.

The Scottish Executive began the *Quality and Standards III* process during 2003. *Quality and Standards III* sought to build on the successes of its predecessor, but also to ensure that there was an even more wide-ranging debate about investment priorities within the industry. There has been a relatively slow start in delivering *Quality and Standards II* and it will be important to consider just how much disruption to local communities and how many projects can be effectively and efficiently managed.

2.4 The views of customers and the level of service

2.4.1 The position before 2001

Prior to 1999, the Scottish Water and Sewerage Customers Council which this Office replaced in 1999 had undertaken an extensive programme of public meetings. The Council also made early attempts to compare the level of service offered to customers by the three water authorities. It dedicated considerable resources to the handling of complaints and to raising awareness about customer service issues. After this Office was established in 1999, we looked to build on the strong consultation programme that had been established by the Council. We also wanted to improve the robustness of the comparison of the level of service provided to customers.

2.4.2 The approach that we used in 2001

We used a range of qualitative and quantitative approaches to understand customers' priorities. These included an extensive consultation programme; a review of complaints and the way in which they were handled; analysis of the approach of other regulators; and two postal surveys.

The Water Industry Act 1999 established a Consultative Committee for each of the three water authority areas. The role of the Committees was to advise the Commissioner on the promotion of the interests of customers in each of the three areas. The Commissioner chaired a number of Consultative Committee public meetings throughout Scotland; we also invited the local water authority to attend these meetings. The meetings provided a useful forum for discussion about customers' concerns. A particular area of concern in many areas (especially in the north) was the issue of affordability of charges for vulnerable customers. We therefore worked separately with a number of organisations that represent or work with these customers to understand the extent of the problem and what could be done.

We were also keen to ensure that we understood the concerns of non-domestic customers. We undertook two separate initiatives: we set up a Large User Group to discuss the specific issues of the largest customers; and we arranged meetings with a number of representative organisations and trade associations.

A second important source of information about the issues that concerned customers were the complaints that we received from customers and our audits of how each of the water authorities handled complaints. Our Office has a statutory duty to deal with unresolved complaints about the level of service provided to the customer by their water and sewerage supplier. The range of issues raised with us either by telephone or in writing is generally broader than those raised at public meetings. In 2000, we introduced regular audits of the way in which the authorities handled complaints. These audits sought to determine whether the authority complied with its code of practice, and responded in an appropriate, timely and complete way to customers. These audits identified the strengths and weaknesses of customer complaint handling within the authorities and informed some of the recommendations that we made in the *Strategic Review of Charges 2002-06*.

A third important area of work was to look at the experience of other utilities and other regulators. We also sought information from the water authorities about customer debt. This information was important in assessing the scope for competition, the impact of price harmonisation and whether the domestic billing arrangement that was in place at that time was in the interests of domestic customers.

We were also keen to complete some quantitative research. This was completed jointly with the three authorities. The consensus was that it would be useful to test customers' opinions on at least two occasions. It was therefore decided that we should establish a 'Water Panel' of 2,250 members (750 from each former authority). Each of the three separate panels reflected the geography and demographics of that water authority area. We completed two postal surveys before we wrote the Review. These surveys sought views about charges, levels of investment, the priorities for investment and more generally what customers thought about the level of service they received. Results from these surveys were included in the *Strategic Review of Charges 2002-06*.

2.4.3 Developments since 2001

The Consultative Committees created in the 1999 Act were disbanded by the 2002 Act that created Scottish Water. The Water Customer Consultation Panels assumed their function. The Panels have an important role in bringing customer issues to our attention and we are keen to work with them.

Our current intention is to seek to build on the consultation programme and analytical work that we completed for the 2002 Strategic Review. Our work programme for the next two years was outlined in our publication *Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges 2006-10* (July 2004).

2.5 The potential for competition

2.5.1 The position before 2001

The Competition Act 1998 took effect at the end of March 2000. In the interim Strategic Review of Charges we highlighted the potential risks of competition. We also identified that broadly cost reflective prices were in the general customer interest. Broad cost reflectivity was important because there was a risk that some larger customers may seek to leave the network or to reduce their usage. Either outcome would have resulted in increased bills for all other customers.

2.5.2 The approach that we used in 2001

During 2000 and 2001, there was a great deal of discussion within the British water industry about how competition might develop. A number of smaller new entrants were already seeking to win business. Some larger utility companies were dedicating considerable resources to analysis of the market.

Our approach was two-fold:

- to assess developments in the market; and
- to conduct a detailed analysis of the industry's structure in Scotland and assess where and how competition might develop.

Notwithstanding the considerable debate about competition in the water sector, there did not appear to be a great deal of activity. Indeed, smaller new entrant to the market appeared to be becoming increasingly marginalised. This impression was, however, a little misleading. Larger companies were increasingly seeking to negotiate about the level of service they received and the price they paid. Companies used the threat of 'off-network' solutions to their water and effluent needs to strengthen their negotiating position and to reach 'special agreements' with the authorities. Our observation of this activity suggested that some services and risks were not being correctly priced. This covered the initial cost to connect, the cost of maintaining a back-up supply and the environmental or political risk relating to private discharges or abstractions. We wanted to understand the effect that such deals would have on other customers and therefore requested information from the authorities about the special agreements.

It is in the general customer interest to avoid 'cherry-picking' within natural monopoly industries. Cherry-picking results when a new entrant (who is no more innovative or efficient than the incumbent supplier) offers a lower price to a customer. This could result from poor cost allocation or from the setting of tariffs that are not reflective of the cost to supply.

The approach we adopted considered the value chain of the industry, in terms of both a series of business processes and a series of stages at which value is added. To assist in this analysis we used Michael Porter's Five Forces model and distinguished between 'for the market' and 'in the market' competition.

'For the market' competition can exist where a company can define a business process that could potentially be undertaken on its behalf by another organisation. This may be central to the organisation (for example, a water company contracting out its operations and customer service activities) or peripheral (such as cleaning activities). For the market competition is unlikely to lead to greater choice for the customer, but it may lead to lower prices.

'In the market' competition exists where the customer ends up with a genuine choice of supplier. It can exist only where an activity or asset base can be replicated with relative ease. 'In the market' competition is only likely to exist for final customers if the industry maintains a vertically integrated structure. Policing of transfer prices between elements of a vertically integrated corporation is likely to be a major barrier to entry for a new entrant.

In addition to the value chain analysis, Porter's Five Forces model was used to understand 'in the market' competition. The model suggests that there are five basic competitive forces that characterise any industry. The five forces are as follows:

- Threat of entry – the threat of competitors entering into the market depends on the barriers to entry. Barriers include economies of scale, government policy and capital requirements.

- Intensity of rivalry among existing competitors – rivalry occurs because one or more firms feel the pressure or can see an opportunity to improve position. Factors affecting rivalry include slow industry growth and high fixed costs.

- Pressure from substitute products – products which can carry out the same function as other products limit the returns of an industry by placing a ceiling on the prices firms can profitably charge.

- Bargaining power of buyers – the ability of buyers to bargain is powerful if, for example, there are low switching costs or where the buyer group is concentrated or purchases large volumes relative to seller sales.

- Bargaining power of suppliers – suppliers exert bargaining power over participants in an industry if, for example, it is more concentrated than the industry it sells to or it poses a credible threat of forward integration.

We applied the results of our analysis to understand the likely implications for customers. This involved additional research into the development of competition in the gas and electricity markets; price trends in the gas and electricity markets; and the discount required to encourage a customer to switch supplier. This analysis was central to our recommendation that the Scottish industry should focus on efficiency and broad cost reflectivity in its pricing. We also concluded that there may be scope for competition in the retail activities of the water and sewerage industry.

2.5.3 Developments since 2001

Scottish Water has made progress in introducing more broadly cost-reflective charging. The Scottish Executive launched a consultation in July entitled '*Paying for Water Services 2006-10'*. The Scottish Executive has also introduced a Bill to the Scottish Parliament, which will establish a framework for competition in customer service and billing. Potential new entrants will have to apply for a license.

2.6 The opportunity for efficiency

2.6.1 The position before 2001

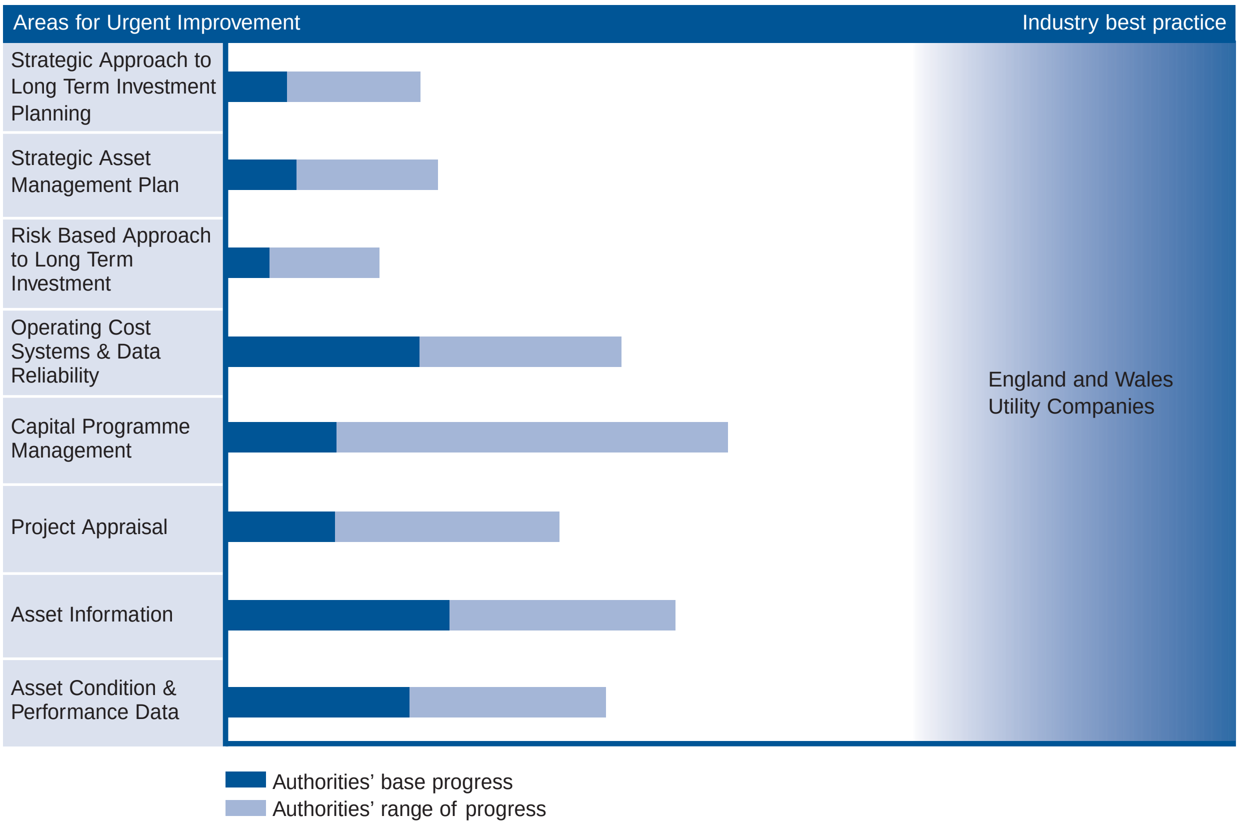
Prior to 1999, no detailed analysis had been undertaken of the efficiency of the water industry in Scotland. At one of the early evidence sessions to the Transport and Environment Committee in 2000, each of the three water authorities claimed to have improved its efficiency by 25% since 1996.

We asked each of the authorities to substantiate their claim. Our conclusion was that their method was not robust. We did not believe that the comparison used by the authorities was consistent with an economic definition of an efficiency. The definition that we use is that “an equivalent or better level of service is delivered to customers at a lower cost”. An important consideration is that comparisons are made on a like-for like basis. The authorities’ assessment was of efficiency resulting from a comparison of current costs with a projected budget for the authorities that had been developed before the three authorities were created.

Within the information project (in section 2.2, above) we examined the techniques employed by other regulators in setting efficiency targets. We concluded that Ofwat’s approach was broadly applicable to Scotland. However, we had to adjust the approach to reflect Public Private Partnerships and the large number of small waste water treatment plants operated by the Scottish industry.

We also needed to determine how best to approach an assessment of capital efficiency. We asked W S Atkins and Yorkshire Electricity to assess the asset management processes of the three authorities relative to best practice. Their conclusions are shown in Figure 2.1.

Figure 2.1: A view of the three authorities’ position compared with industry best practice



Early results from the information project suggested that there would be considerable scope for efficiency, both in operating costs and capital expenditure. Given the size of the capital programme that was being discussed in *Quality and Standards II*, this scope for efficiency was likely to be important in ensuring that increases in customer charges could be restricted to an acceptable level.

2.6.2 The approach that we used in 2001

We used benchmarking to establish the potential scope for efficiency in both operating and capital costs. The information project allowed us to compare levels of performance and cost in Scotland with the companies south of the border.

The first step was to assess a level of base operating costs. This is the level of costs that would be required simply to maintain the current level of service. The base level of operating costs is established after adjustments for one-off items or events. Examples include the costs of dealing with the ‘Millennium Bug’ or unusual weather conditions. Costs can increase to the extent that the level of service is improved or a greater number of customers are served. Efficiency targets are applied to both the base level of operating costs and to any additional operating costs allowed for improvements in the level of service to customers.

Once we had established the base level of operating costs for each of the three authorities, we conducted a number of high level benchmarking exercises to compare the water authorities’ unit costs with those of the companies in England and Wales. We then identified appropriate comparator companies for the former water authorities. This was based on factors such as the size of the customer base and the ratio of infrastructure length (mains and sewers) to the numbers of customers.

We closely followed Ofwat’s ‘top down’ approach to setting operating efficiency targets. Adopting such an approach allows a more complete and objective assessment of performance. There is no attempt to identify particular cost elements by building up a total, item by item. We adopted this approach for several reasons:

- Ofwat had recently conducted a price review in England and Wales;
- The authorities did not have sufficiently detailed cost allocation in place to facilitate a ‘bottom up’ approach; and
- We wanted to avoid any suggestion that we were dictating how targets should be achieved.

Ofwat uses econometric modelling in assessing relative operating efficiency. Details of Ofwat’s operating efficiency models were published in Ofwat’s technical paper *Assessing the scope for future water and sewerage efficiency* (April 1998). They were updated in Regulatory Director letter RD2/99 (January 1999).

These econometric models allowed us to benchmark the Scottish water industry against that of England and Wales. The models were designed to take account of many of the differences in demographics and geography of Scotland compared with England and Wales. However we did adjust the models to ensure that we had taken full account of all unavoidable cost differences.

We set the actual operating cost efficiency targets relative to the expected level of efficiency of the comparator companies in 2005. There was a clear gap in efficiency between the industry in Scotland and the comparator companies. We therefore sought to establish an appropriate target that would be challenging but achievable. To establish such a target we looked at the performance of the companies relative to the leading company over a five-year period. We observed that, on average, a company closes 85% of the gap to a leading company during a five-year regulatory period. On this basis, we decided that an appropriate and achievable target was that the industry in Scotland should close 80% of the gap to the comparator companies by 2006.

Our analysis of efficiency targets also took account of the different levels of service provided to customers in Scotland and in England and Wales. The 'top down' nature of the models meant that we assumed that improvements in water quality should not require additional operating costs. We did allow some new operating costs to reflect the costs of additional sewage treatment.

One important factor that we also took into account was the Competition Commission's view that a regulator should not rely solely on one method for calculating the companies' relative efficiency. We therefore developed a detailed alternative model. This model used a different approach and different information. The efficiency gaps assessed by this model were broadly similar to those calculated using the Ofwat methodology.

Efficiency in capital expenditure is more difficult to assess and to monitor than efficiency in operating costs. We divided the planning and delivery of capital expenditure into four distinct areas. This approach simplified the assessment of relative performance in discrete areas. The potential for efficiency would therefore be the sum of the efficiency identified at each of the four stages:

- Strategic asset management – these are savings that can be made by not spending money that was allocated. In terms of efficiency this must be done without sacrificing output. An example would be replacing pumps every five years as opposed to every three years.

- Programme planning or investment appraisal – these are savings that result from finding the most cost-effective way to deliver objectives. Investment appraisal questions whether a project delivers its objectives in the most cost-effective way.

- Procurement – these are savings that arise from improved procurement of capital projects. This would include the initial contract, management of delivery and commissioning of the asset. We are able to use the information supplied to us in the Annual Return, and similar information provided to Ofwat, about the costs of standardised capital projects in order to assess the potential for savings.

- Innovation – these are savings that come from 'doing it the new way'. The Babtie Report[2] into lower cost technologies and processes in the water industry was a key input in this area.

Our review of the approaches used by regulators in assessing capital efficiency suggested that Ofwat's approach could be modified to take account of the situation in Scotland. This had two advantages. Firstly, adapting the Ofwat approach would help ensure that we would not double count the potential for efficiency. Secondly, we had most of the information that we would need in order to make a robust assessment of the scope for capital efficiency.

Unfortunately, we were not able to use the Ofwat econometric models because we did not have sufficient information about the performance of assets in previous years. We therefore had to rely on comparisons of the cost base information supplied to us by the three authorities and to Ofwat by all of the regulated companies. This cost base allows us to assess the scope for efficiency in procurement. The authorities' cost base information was for 2001. The most recent equivalent information from the companies south of the border was from 1998. We assumed that the companies south of the border would have continued to improve their procurement costs by 2.5% nominal a year for the three years after 1998. We further assumed that this rate of improvement would continue until the end of the regulatory period in 2005-06.

The scope for improvement through innovation was taken from the Babtie report.

Identifying the scope for efficiency in strategic asset management and programme planning is more difficult. We assessed the scope of improvement achieved by the companies south of the border that was not explained by procurement or innovation. We conducted structured interviews with a number of companies about how they

[2] Babtie Environmental, Report and opinion on the scope for widescale adoption of lower cost new technology and practices in the water industry, Ofwat, 1998

analysed capital expenditure, how this had changed, and the savings they had realised. We were also able to draw on the W S Atkins and Yorkshire Electricity assessment of the asset management processes of the three authorities relative to best practice.

This approach is summarised in the following table:

Table 2.1: Methods for assessing capital efficiency

Area identified for efficiency	Tools
Strategic asset management	Information project, industry consultation, benchmarking
Programme planning (appraisal)	Information project, industry consultation, benchmarking
Procurement	Cost base analysis
Innovation	Babtie Group report

We were aware that there was a considerable efficiency gap in the delivery of capital investment. On balance we considered that it would be better to set the target on the same basis that we had used for operating expenditure. The capital target was therefore set at 80% of the gap in efficiency between the industry in Scotland and the Ofwat benchmark (not the leading companies). We also decided to phase the capital efficiency targets.

We applied the capital expenditure efficiency target to 92% of the Quality & Standards capital programme, as approximately 8% accounts for capitalised operating cost. The operating cost efficiency targets were applied to the capitalised operating cost.

2.6.3 Developments since 2001

The information available to us and to the Scottish industry has continued to improve. This will extend the scope of our future analyses of the scope for efficiency.

Useful work has also been carried out by UKWIR, involving the industry and its regulators, to assess the need for capital maintenance.

2.7 The calculation of a revenue requirement

2.7.1 The position before 2001

Prior to 1999, there was no strategic approach to the assessment of the revenue needs of the industry in Scotland. Each year the three water authorities had to agree their scheme of charges with the Scottish Water and Sewerage Customers Council. Long-term investment needs and the impact of increased borrowing were not modelled in detail and, it would seem, their full implications were not understood.

The three authorities took account of the level of increase in tariffs they thought would be acceptable; the investment programme they would be asked to deliver by Government; and the public expenditure available.

In 1999, the Scottish Executive asked this Office to conduct an interim Strategic Review of Charges covering the 2000-01 and 2001-02 financial years. We developed a financial model to allow us to consider the impact of different levels of borrowing and capital expenditure. Our analysis showed that each of the three authorities would need a significant increase in its revenue if it were to be able to meet its current capital expenditure obligations. It also became clear that the need for capital expenditure would continue for the foreseeable future.

2.7.2 The approach that we used in 2001

The main aim of any price review is to establish an appropriate level of prices. It is important that the outcome is consistent with the medium and long-term needs of the industry and with the interests of customers. We do not want to swap present problems of underinvestment for future financial problems. This would not be in the interests of customers. The financial model that we developed for the *Strategic Review of Charges 2002-06* allowed us to vary all of the potential financial inputs.

We used the financial model to determine an optimum profile for revenue. Our aim was to establish a series of revenue caps for the 2002-06 period such that customers could expect future revenue increases to be held below the rate of inflation – in the absence of any significant tightening of environmental and public health standards and if the industry improved its efficiency.

The model was reviewed and improved by Cap Gemini Ernst and Young and was audited by Scott Moncrieff, a leading firm of Scottish accountants.

2.7.3 Developments since 2001

In the *Strategic Review of Charges 2002-06* we set challenging but realistic targets for Scottish Water. Scottish Water's recent performance confirms that the targets were realistic and achievable. There is therefore a clear possibility that customers can look forward to an extended period of stable prices in real terms.

While we have confidence in both the targets and the revenue caps that we set for Scottish Water, we recognise that we should ensure that the calculation of the revenue caps can be compared with those of the companies in England and Wales with greater ease:

- *Comparability* – most other utility regulators establish an appropriate level of revenue by using a regulatory capital value (RCV). The RCV earns a return, and depreciation and allowable operating costs are added to determine the level of revenue allowed to a company. The RCV is increased if capital expenditure in a year is greater than the depreciation charged. We will discuss switching to the RCV method of price setting in our consultation on price setting.

- *Funding underperformance* – under the approach used for the Strategic Review of Charges 2002-06, if Scottish Water were unable to achieve the efficiency targets assumed in the revenue cap, then customers' prices would increase in the future. In future we would be keen to ensure that customers are not exposed to this risk.

- *Transparency* – we agree that it would be desirable to make it clearer how much investment is paid for by current customers, and how much is being deferred to future customers through debt.

2.8 The application of a risk analysis to the proposed revenue caps

2.8.1 The position before 2001

There was little, if any, discussion about either operational or financial risk before 2001. If a water authority ran short of funds, it could either increase its creditors or delay some of its capital maintenance. Prior to the introduction of the Annual Return, it was impossible to know whether or not the authority had delivered the outputs included in its corporate plan, and if so to what extent.

2.8.2 The approach that we used in 2001

By early 2001, it was evident that there was significant scope for efficiency in the Scottish water industry. It was also clear that to achieve this efficiency would mean halting and reversing a trend of worsening performance that could be traced back to at least 1996. Increased investment was required to meet the *Quality and Standards II* obligations. There was a clear concern that if prices were set too low, and if the industry did not achieve its efficiency targets, it may end up borrowing too much. The result would be that we had swapped a problem of under investment with one of a large debt burden. This would worry the Scottish Executive both from the standpoint of managing its own budget and because of the longer-term implications for customers. It is not clear that customers are prepared to pay a lot more to keep the industry in the public sector.

In the commissioning letter for the *Strategic Review of Charges 2002-06* we were requested by the Scottish Executive to complete a formal risk analysis. We were pleased to complete this analysis as it focuses on the assumptions behind the efficiency targets for operating and capital expenditure. In assessing the scope for efficiency we had relied on comparisons with England

and Wales. As such we knew that achieving the efficiency targets would depend on significant cultural change within the industry. The range of the potential performance outcomes could be observed from the history of the companies south of the border. By undertaking a formal risk analysis we were able to increase our own confidence in the analysis that we had completed.

Our financial modelling had shown that customer charges in the future depended on taking a prudent view on borrowing. We were aware that any underperformance on either operating or capital efficiency targets would increase borrowing. Not only would this be bad for customers in the medium to long term, it would also breach the public expenditure constraint included in the Minister's commissioning letter for the Strategic Review of Charges. The risk analysis demonstrated that the revenue caps were consistent with the aims of the Review.

2.8.3 Developments since 2001

We would expect to conduct a similar risk analysis for the *Strategic Review of Charges 2006-10*. We believe that the risk analysis conducted for the last Review was thorough and robust and we have no plans to make material changes to it.

Since 2001, the industry improved considerably its understanding of the condition and performance of its assets. As a result, it has become more aware of the risks of asset failure. Such new awareness should not be confused with increased risk – indeed, knowledge that a risk exists allows it to be managed, so results in an actual reduction in the total risk. We are pleased to note the increased awareness of risk within the industry and welcome the attempts by the industry to improve its management of risk.

Section 1: Chapter 3
Outcome of the Strategic Review of Charges 2002-06

3.1 Introduction

The focus of the *Strategic Review of Charges 2002-06* was to set revenue caps that were consistent with a sustainable water industry in the public sector. Our analysis showed that to ensure a sustainable water industry in the public sector it would be necessary to take action in the following areas:

- increased revenue to the minimum level consistent with meeting ongoing maintenance and environmental/public health compliance;
- challenging but achievable efficiency targets;
- further improvement in customer service;
- harmonised and broadly cost-reflective tariffs;
- improved regulation and financial control;
- improved performance monitoring; and
- better governance.

We remain of the view that the Review addressed all of these issues, although inevitably there were some unexpected consequences of the actions we recommended. An example of this is the size of the percentage increases in bills for some non-domestic customers. While we recognise the concerns of these customers, it is not clear that we could have acted differently. We have to balance the interests of all customers, and every customer who pays below the average cost of supply for the service they receive is gaining at the expense of other customers. After completing the Review, we approved and supported the move to harmonise charges immediately for businesses across Scotland. Our analysis had shown that the impact would be less adverse and fewer customers would be affected by a swift movement to remove anomalies that existed between various parts of Scotland. It is important to remember that even if the difference in tariffs had been reduced by half, water customers in the north would still have been paying some 40-50% more for the water they consumed.

We accept that there should have been more effective communication about the changes in tariffs and their implications. However, the Strategic Review of Charges did highlight the impact that harmonisation and more cost-reflective charging would have on a number of different types of business.

3.2 The level of revenue

In the Strategic Review of Charges, we showed that the Scottish industry had spent considerably more, in the past several years, than it had received in customer charges. We explained that this was a problem because there was a likelihood that sustained investment at current levels would be required for the foreseeable future. The Scottish Executive's recent Consultation document *Investing in water services 2006-10* confirms that investment in the next regulatory period will certainly be no lower than in 2002-06. It is also clear that investment at these levels will continue for the foreseeable future.

Continuing to increase net borrowing significantly to eliminate the gap between revenue and expenditure will only make matters worse. Borrowing may delay a price increase, but it will increase future bills by the interest payable on any additional borrowing. It will also, as we explained to the Finance Committee inquiry in 2004, expose the industry to greater financial risk. This is not in the customer interest. In providing our advice on the level of revenue, we took into account a clear customer concern that the industry had "to get its house in order" and that, as a commodity business, "it should learn to live sustainably without real increases in price". We believe that the revenue increases that were implemented will ensure that we have a more sustainable industry in the future and that customers will see the benefits in steady prices. If Scottish Water continues to make progress in reducing its costs, it is possible that prices will not need to increase in real terms.

The principal output of a Strategic Review of Charges is a recommended revenue cap. It is for management and the owner to determine how best to use the resources available within this revenue cap in order to deliver the agreed improvements to levels of services. This explains the importance that we attached to a recommendation that executive directors were incentivised to meet customer service, environmental and public health outputs within the revenue cap. Meeting those outputs would require management to meet targets at an aggregate level rather than meet every target individually. In other words, management could outperform on efficiency targets and do less well on contributions from new business and still be in a good position to meet the agreed outputs. As such, when we set the revenue cap and included clear targets for efficiency, assumed contribution from new business and the proceeds of property disposals, these were a means to an end, rather than an end in themselves. It is not in the customer interest that management is judged against the means to an end, rather than against the achievement of agreed levels of service for customers.

3.3 Challenging but achievable efficiency targets

The *Quality and Standards II* process highlighted that there was a need for increased investment. It was also likely that some of this investment in higher treatment standards would result in higher operating costs. There was therefore a significant upward pressure on the prices faced by customers.

In the Strategic Review of Charges we explained that the need for increased revenue could be markedly reduced by an improvement in the operating cost and capital expenditure efficiency of the Scottish water industry. Our analysis showed that the level of efficiency of the Scottish industry had been declining at a time when the industry south of the border had been significantly improving its efficiency (see Figures 3.1 and 3.2).

Figure 3.1: Trends in base operating costs since 1996-97[1]

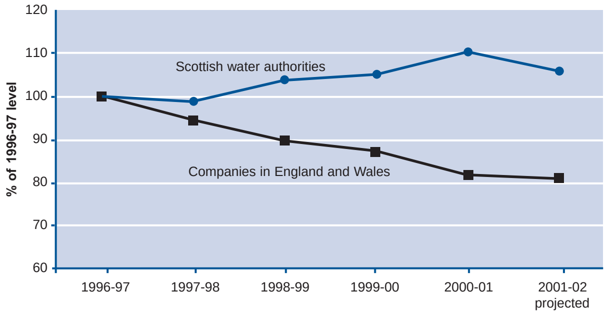
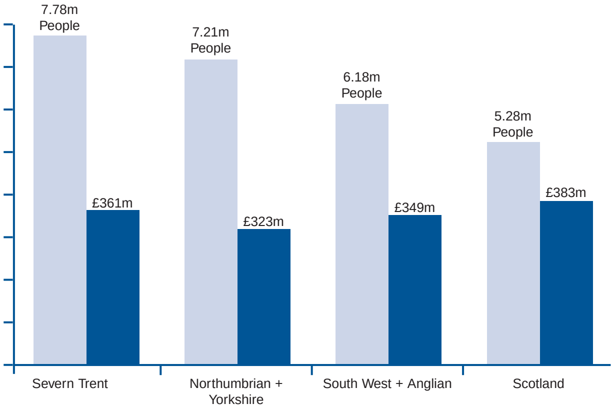


Figure 3.2: Comparison of operating expenditure and population served 1999-00



The charges paid by customers in the public sector model are a direct function of the efficiency of the water industry in Scotland. Unlike in the private sector, there are no dividends for shareholders from any profit. Any surplus in Scotland can go wholly to financing investment and improving the service to customers. There are no trade-offs between the customer and the shareholder. In this regard it is important to define what we mean by 'efficiency'. Cost cutting is not efficiency. Efficiency is about reducing costs and maintaining or improving the levels of service to customers.

We set three separate efficiency targets to cover operating costs, capital expenditure and the potential savings resulting from the merger of the three authorities. These efficiency targets were challenging

[1] It is important to note that there have been significant improvements to drinking water quality and environmental compliance during the past five years.

but achievable. After two years, we can see real progress in reducing operating costs. Scottish Water is also confident that the creation of Scottish Water Solutions will improve both the timeliness and efficiency of the delivery of capital investment.

Our advice on revenue caps also allowed some £200 million in ‘spend-to-save’. The aim was to ensure that Scottish Water would be able to meet all of its restructuring costs without delaying investment or improvements in customer service.

The total annual value to customers if Scottish Water achieves the efficiency targets is in excess of £400 million a year by the end of the current regulatory period in 2005-06. This would result in customers’ bills being some 40% lower than they would otherwise have been. These efficiencies are important because a sustainable water industry needs to be affordable both now and in the future.

3.4 Further improvement in customer service

In the Strategic Review of Charges we noted the improvement that there had been in customer service since 1996. Improved Guaranteed Minimum Standards are in place, although there is some way to go to improve compliance. Only a relatively small number of customers have cause to complain about their water and sewerage service.

However, when they do have cause for complaint, the consequences of service failure can be serious. Our public meetings both before and after the Review continue to show that an increasing number of customers believe that they should have a choice in supplier. In addition, an increasing number of customers are comparing the service they receive with other utilities such as electricity, gas or telephone. Improvements in customer service are likely to be an important element in any response to retail competition.

The Review outlined in detail why we considered that competition should pose only a limited threat to Scottish Water. We suggested that Scottish Water could mitigate the risk of competition by introducing a system of harmonised and broadly cost-reflective tariffs. It was clear, however, that Scottish Water may lose revenue relating to its customer service and billing (retail) activities. These activities constitute around 15% of total revenue, so even if a significant percentage of this revenue were lost, there would be only a relatively minor impact on the rest of the business.

Analysis of the development of retail competition in other utility industries suggested that Scottish Water may lose a significant number of customers, but that this was likely to take time. The experience of other incumbents facing the opening of their market to competition was that customers are often prepared to pay for improved customer service and accurate billing.

It was therefore important that Scottish Water improved its customer service. However, the risk of losing retail customers because of poorer service needs to be put into context. If Scottish Water lost half of its retail customers by value, this would result in an approximate reduction in the total revenue available to Scottish Water of £75 million. Even if Scottish Water could reduce this customer loss by half, because of improved customer service, the total benefit to Scottish Water would be less than £40 million a year. While this saving is clearly worth having, it is not significant relative to the value of the cost efficiencies that have been identified.

If the Scottish Executive’s current proposals for competition are approved by the Parliament and a retail subsidiary company is established, this would change the priorities of parts of the currently vertically integrated Scottish Water. The retail subsidiary would sensibly focus on improving customer service, while the remainder of Scottish Water should continue to focus on improving its efficiency.

3.5 Harmonised and broadly cost-reflective tariffs

When the Minister for the Environment, Sport and Culture, Sam Galbraith, MSP announced his intention to merge the three water authorities to the Transport and Environment Committee in February 2001, he highlighted the harmonisation of charges as an important benefit. There were clearly significant anomalies in the charges that resulted from the three-authority model. It is, for example, much cheaper to supply Dundee than North Fife, yet charges were much higher in Dundee. It was more expensive to serve south Ayrshire than the western Central Belt, yet charges were the same.

We considered that a harmonised charge across Scotland was equitable for all customers. To charge otherwise would have been to sanction a postcode lottery in charges for water. It would also break with normal practice in the pricing of utility services – ie to harmonise prices across the whole of a company's area.

There has been some discussion about our recommendation that charges for businesses should also be harmonised across Scotland. We considered that this was important for the following reasons:

- The merger of the three authorities only made sense if cost savings, investment prioritisation and a single management structure were to be introduced. This would remove the justification for differential pricing for the three former areas. The choice therefore is between wholly cost-reflective charging (which will disadvantage the smallest and most rural) and fully harmonised charging.

- Businesses, like households, should not be asked to pay more solely because of their location.

- The distinction between some households and non-domestic customers was blurred, for example people who work from home, farms and crofts, owners or managers with accommodation in hotels or on school and business sites.

My view remains that it would have been difficult for Scottish Water to defend different pricing regimes in different parts of Scotland. We accept that there was probably insufficient debate about the impact on customers in the former east and west areas. In this regard, the Scottish Executive's consultation *Paying for water services 2006-10* should improve customers' understanding of the alternatives.

When we began to examine the costs incurred by the three authorities in detail, we noted that each of the three authorities allocated costs to activities quite differently. It was also clear that there were considerable differences between the authorities and the companies south of the border. We concluded that there was a need to understand the whole-life costs of water and waste treatment, operating and maintaining the water and sewerage networks and customer service and billing.

There was and still is a lot of talk within the industry of the competitive threat posed by 'common carriage'. Common carriage is where a third party supplier can request the owner and operator of the water mains to accept treated water into the system in order that the third party supplier can take a similar amount of water out of the system to service a customer. In theory, if the price for conveying water is the same as the averaged cost, the incumbent should be happy to provide this service. The risk in reality is that the third party can be more effective either at treating water or in serving customers and can therefore gain competitive advantage. However, this does bring to light the need to price the use of the system correctly. The consequence of incorrect pricing will be an increase in 'cherry-picking' and an increase in prices for those customers who either choose or have to remain with the public supplier.

At the Strategic Review of Charges, we were concerned that Scottish Water would be vulnerable to challenge from new entrants if its decisions on tariffs were perceived to be inconsistent. The tariff structure did not reflect the economic costs of supply and, as a result, was sending inappropriate signals to customers. For example, how could it be possible to justify providing a service to a customer for less than the cost of billing that customer? And why could a new entrant not request a similar price from a similar customer in a similar area?

We still believe that a level of risk remains, although the more broadly cost-reflective charges that have now been introduced have helped. In our view, there are still issues concerning the pricing of back-up supplies and for the largest occasional users of water. The balance between sewerage and trade effluent charges will also need careful consideration.

As we gain a fuller understanding of Scottish Water's costs, it is likely that our views on the appropriate balance between fixed and variable charges may alter. However, we believe that the moves that have been made to date are in the right direction and that as a result Scottish Water will be able to meet competition on a level playing field. Our view remains that it is in the general customer interest to have more broadly cost-reflective tariffs.

3.6 Improved regulation and financial control

Over the past four and a half years we have dedicated significant resources to establishing a robust and objective regulatory reporting regime. We were fortunate that we could draw on the information contained in the Annual Return to write the *Strategic Review of Charges 2002-06*. This was the first time that such standardised information had been available.

In the past two years we have made a considerable effort to improve further the overall quality of management information. This will be crucial to improving the financial and customer service performance of the industry.

In the Review we commented on a need for the financial control and management of the industry to be improved. We are pleased that we have seen significant efforts from Scottish Water to improve its financial systems and its understanding of its costs. This is important because a detailed understanding of where costs are being incurred is fundamental to a sustainable reduction in operating costs.

The Scottish Executive's proposals to establish a framework for retail competition is also to be welcomed, as the experience in other utilities suggests that clear legal and accounting separation would probably highlight a number of areas of cost that do not add value to customers. The proposals are in line with our advice in the Review about the separation of activities. It is important to note that this separation is likely to benefit all customers, not simply those who are able to switch suppliers.

3.7 Improved performance monitoring

Monitoring performance is central to regulation. This explains why we sought ministerial approval for the annual reports on the performance of the industry in Scotland and for a joint project with the quality regulators to agree how the outputs of the capital investment programme should be monitored. Increased information about performance is only valuable if, as a result, customers receive a better level of service or the costs of the industry are sustainably reduced.

Performance monitoring has developed significantly in the two years since we published the *Strategic Review of Charges 2002-06*. This monitoring takes two forms: the on-going collection and analysis of information; and the publication of annual reports on:

- costs and performance;
- investment and asset management; and
- customer service.

These reports provide objective analyses of the current performance of the industry in Scotland. Their message is clear: that there is significant scope for improvement. This message will, of course, not be popular with the senior management of Scottish Water; however, our monitoring would suggest that in a few years time these reports will serve as useful evidence of the improvements and better value for money that have been achieved.

We believe that our monitoring of performance has already brought results. In its second year, Scottish Water performed much better than initial drafts of its business plan had suggested would be possible. Our monitoring of the capital programme will also ensure that we can manage the transition from the *Quality and Standards II* to the *Quality and Standards III* period effectively. This will ensure that there will be no question of customers paying twice for the same promised improvement.

We are also continuing our monitoring of complaints and consultation with customers to inform the next Strategic Review of Charges and to improve current levels of service.

3.8 Better governance

We believed that better governance would be vital if the performance of the Scottish industry was to improve. It is therefore encouraging that the Scottish Executive has adopted many of the recommendations that we made at the last Review.

We made five principal recommendations at that time. These recommendations, and the current position, are outlined below:

Recommendation:

There should be well-defined responsibilities for the Scottish Executive's de facto ownership role, the Board and the senior management, ensuring that accountability of each party is rigorous and transparent.

Current position:

The Scottish Executive is introducing a much clearer regulatory framework. The current preparation work for the *Strategic Review of Charges 2006-10* is consistent with this new regulatory framework. Ministers will take clear decisions on the levels of investment and the investment priorities. They will also provide guidance on how customers should pay for water and where they want to see cross-subsidies.

Scottish Water will have to draft a business plan that takes full account of the guidance from Ministers and outlines their strategy objectives and views on prices for the next regulatory period. This business plan will have to be approved by the Board. The Board will have to present this plan to the economic regulator. Ministers will use a first draft of this plan to inform the guidance that will underpin the second draft.

The economic regulator will consider the information provided by Scottish Water in its Annual Return, its other information submissions and its second draft business plan alongside representations from stakeholders in determining the minimum level for charges that is consistent with the guidance received from Ministers.

Recommendation:

There should be high-quality, commercially experienced non-executive board members who will bring openness, thoroughness and objectivity but also be able to question and advise senior management when necessary about the operation of the business.

Current position:

The Board of Scottish Water has eight non-executive members. These members bring extensive experience of different business sectors and sizes. In particular, they have significant expertise in utilities, asset management and finance. The Board can also draw on important expertise in large change programmes and human resource issues.

Recommendation:

The right balance should be struck between executive and non-executive directors. The Board is crucial in supervising the drive for efficiency.

Current position:

There are eight non-executive and five executive members of the Board.

Recommendation:

There should be transparent and appropriate incentives and penalties for executive board members and for senior management to ensure that the right calibre of professionals is attracted to the industry.

Current position:

Senior management can earn bonuses. The remuneration committee of the Board sets these bonuses based on performance criteria established at the start of the year. In Scottish Water's annual report last year, information was provided about how individual bonuses had been calculated.

There may still be room to improve the transparency of the incentive system. Best practice would suggest that the performance measures that will be used to determine bonuses will be published in advance and should be independently measurable and verifiable.

Recommendation:

There should be clear setting of the risk profile by the owner, followed by management of risks by the Board to the criteria established by the owner.

Current position:

The strengthened governance and regulatory framework described above should ensure that this recommendation is met.

It is encouraging that the Scottish Executive appears to be learning from the experience of other utilities and the water industry south of the border. There has been a significant improvement in the value for money offered by the electricity and gas companies in the past ten years.

There are two principal reasons for this improvement:

- Regulation has encouraged comparative competition and helped force costs down by setting strict caps on revenue; and
- Competition has been effective in reducing costs within the regulated monopoly part of the business. It has also driven improvements in the level of service offered to customers.

There have been a number of quite high-profile failures in utility businesses. Independent Energy, for example, went into receivership because of failings in customer billing and service. It is therefore to be welcomed that the Scottish Executive wants to introduce a strong licensing regime.

The improvements to corporate governance are also to be welcomed. Effective corporate governance is rarely noticed, but failures become apparent very quickly and often with negative implications for customers (and owners).

We were pleased that the Water Industry (Scotland) Act 2002 limited the role of the Water Industry Commissioner for Scotland to the promotion of the interests of customers of the core business. This amendment was made after the Review was published. We believe that this change was in the interests of customers. We recognise that non-core activities may bring value, but evidence from south of the border is that they also bring risk. Moreover, the potential profit from new business is not significant, particularly when compared with the potential gains from achieving the efficiency targets.

In the Review we showed that diversification into other businesses appears to have added limited value to shareholders and that many companies are now looking to divest these activities and return to their core business. Investors also appear to favour companies that are sticking to their core business. We continue to believe that the Scottish industry should avoid the mistakes made by the privatised water industry and that new business opportunities should be approached very cautiously. It is important to weigh the potential of any new business activity with the risks both of that venture and the risks posed to the core business.

In the public sector model, the financing for any non-core activity, whether a small opportunity or an acquisition, comes from customers of the core business or from the taxpayer. We understand that in the new competitive environment there may be a case for providing some limited value added activities to key retail customers; however, it is important that the costs of providing these services are well understood. It may be that the available retail margin does not justify this service.

A good example of a company refocusing on its core business is Welsh Water. Glas Cymru, a not-for profit company limited by guarantee, has acquired Welsh Water. Glas Cymru is owned and controlled by members who do not receive dividends or have any other financial interest in the company. The company is 100% debt financed and is, therefore, an interesting comparator for the Scottish water industry. Analysis of this development suggests that there are three main reasons why Welsh customers will benefit from the new approach:

Focus on costs

The reduction in the cost of capital has had a high profile. From a Scottish viewpoint, it is equally impressive that operational costs will be reduced considerably during this regulatory review period. Glas Cymru is also amongst the leaders in pioneering a partnership approach to the delivery of its capital programme. This is likely to generate significant savings.

Focus on core activities

Limiting activities to the core business of providing a water and waste water service within the Welsh Water area ensures that the management is not distracted from the most important issue, which is reducing costs.

Incentive to management

It is clearly in customers' interests that management is working primarily to deliver the customers' priorities. The alignment of management bonuses with the promised reductions in bills is also a very positive step.

Although the overall model may still not be appropriate for Scotland, it still has clear relevance in the context of the Scottish water industry. At the time of the Review, it was certainly not possible to talk about reductions in average Scottish Water bills during the regulatory period. However, our ongoing monitoring of performance suggests that it may be possible to talk about real reductions in the next regulatory period.

Section 1: Chapter 4
Resource accounting and the Strategic Review of Charges 2002-06

4.1 Introduction

There was considerable debate before the Parliament's Finance Committee about the impact that the introduction of resource accounting may have had on the prices paid by customers of Scottish Water. We believe that the introduction of resource accounting did not impact on the prices paid by customers. Indeed, the introduction of resource accounting led to increased scrutiny of the value of assets owned and the depreciation policies used by the industry. This will have contributed to the progress of the past few years towards a more sustainable public sector water industry that can continue to meet the expectations of customers.

Prior to 1996, the Regional and Island councils were responsible for water and sewerage services. When the three authorities were established in 1996, customers were to pay for water and sewerage services to the new authorities. The Government decided to phase in charges for sewerage to households. This transitional scheme lasted for three years. In the first year household paid a third of the applicable sewerage charge, in the second year two-thirds and in the third year the household was liable for the full charge. The Government paid the balance of the sewerage charge to the water authorities in the form of a grant.

The water authorities were also provided with a borrowing consent. This External Funding Limit (EFL) was a permission to borrow and was scored as public expenditure.

In the first three years after the water industry was reorganised, the water authorities had three sources of funds:

- charges from customers;
- grant from Government (Domestic Sewerage Transitional Relief) and capital grants; and
- borrowing from Government.

The Water Industry Commissioner for Scotland was established in 1999. In 1999, the authorities no longer received the transitional relief from Government and their resources came either from customers or from Government in the form of new borrowing.

Funding of the industry prior to the *Strategic Review of Charges 2002-06* is outlined in Table 4.1.

Table 4.1: Funding of the water industry 1996-97 to 2000-01

Scotland	1996-97	1997-98	1998-99	1999-00	2000-01	% change 1996-2001
Water	£283.8m	£301.2m	£321.5m	£337.7m	£393.2m	38.5%
	n/a	6.1%	6.7%	5.0%	16.4%	
Waste water	£148.6m	£186.6m	£245.3m	£299.5m	£360.7m	142.7%
	n/a	25.6%	31.5%	22.1%	20.4%	
Transitional relief	£90.5m	£59.7m	£29.7m	£0m	£0m	(100%)
	n/a	(34%)	(50%)	(100%)	n/a	
Other	£1.9m	£0.91m	£0.91m	£2.3m	£0m	(100%)
	n/a	(52%)	0%	153%	(100%)	
Borrowings	£182.1m	£166.7m	£165.4m	£212.6m	£208.8m	14.7%
	n/a	(8.5%)	(0.8%)	28.5%	(1.8%)	
Capital grants	£37.6m	£1.6m	£3.2m	£5.9m	£2.8m	(92.5%)
	n/a	(95.7%)	98.7%	85.6%	(52%)	
Total	**£744.5m**	**£716.7m**	**£765.9m**	**£857.9m**	**£965.5m**	**29.7%**
	n/a	**(3.7%)**	**6.9%**	**12.0%**	**12.5%**	

When the three water authorities were created, the Treasury commuted some £700 million of a total of £1,700 million of local regional council debt relating to water and sewerage activities. This left £1 billion debt on the balance sheets of the three water authorities. By 2001, this debt had grown to over £1.9 billion. Interest charges accounted for just under 17% of customer revenue.

The three authorities did not examine the long-term effects of increasing debt at such a rapid pace. An increased EFL allowed price increases to be deferred – there was no assessment of the impact of this decision on customers' bills in the future. Moreover, under any reasonable assessment of the industry's asset base, debt was increasing much faster than the economic value of net new investment.

By the end of 2000, when we began to consider the potential revenue needs of the industry in Scotland to meet the standards that were likely to result from the

Quality and Standards II process, it was clear that there would have to be a more prudent balance between the charges paid by customers and new debt. Moreover, as outlined in the previous chapter, we had identified that there was considerable scope for efficiency in the industry.

We also identified that realising these efficiencies would require a significant cultural change. Our analysis therefore considered the likelihood of the Scottish industry failing to comply with the public expenditure constraint that was likely to be allowed by the Scottish Executive. We therefore conducted a series of risk analyses to examine the relationship between under- or out-performance of our efficiency targets for operating and capital expenditure at various levels of revenue and public expenditure. Our analysis attempted to determine, as objectively as possible, the degree of risk faced by customers.

4.2 Resource accounting

4.2.1. Background

It is important to understand the two principal methods of keeping track of income and expenses in any public or private organisation. There is the resource based (or 'accrual') accounting method and the cash-based method. If implemented consistently, these two methods should only differ in the timing of when transactions are recognised in the organisation's accounts.

Under the accrual method of accounting, transactions should be recorded, as far as possible, in the financial statements for the accounting period in which they occur, and not in the period in which any cash involved is received or paid. Accrual accounting recognises the cost of using a fixed asset or an intangible asset such as a brand by an accounting charge such as depreciation[1] or amortisation[2]. This cost is recognised when the benefit is used, not when the asset was purchased. Under the accrual system, the asset's use has a cost in each year.

Accrual accounting relies on the 'matching' principle. The matching principle requires revenues earned by an organisation during an accounting period to be matched with the expenses incurred in earning those revenues during that period. The difference between revenues and expenses is the profit earned or the loss incurred during the period of reference.

In contrast, cash accounting recognises revenue or expenses when the cash is paid or received. As such, financial statements produced under the cash basis of accounting should be very simple. They cover only receipts and disbursements made in cash, together with the corresponding opening and ending cash balances. Cash accounts exclude all assets and liabilities that are non-cash charges.

Consequently under the cash accounting system a cost may be recognised before the benefit is received. The purchase of an asset that was expected to provide useful service over a number of years would be recorded in the year it was purchased. However, its use in subsequent years would then be 'free'.

4.2.2. The introduction of resource accounting by the UK Government

Cash-based accounting was originally used in the public sector to monitor the use of public cash funds such as tax payments and investments made in cash. Such pure cash accounting became increasingly unsuitable for managing fixed assets and debt. As a consequence, the original cash system was adapted to include non-cash items such as credit approvals for local authorities, and depreciation at an aggregate level. Cash remained the main instrument of control.

In the UK, accounting practices in the public sector began to change with the introduction of market-oriented reforms during the 1980s. The agreement to comply with the UN System of National Accounts (SNA, 1993) provided the impetus for government to develop accounting techniques that could encompass liabilities and assets on an full accrual accounting basis[3].

[1] Depreciation is a measure of the consumption, use or wearing out of an asset over the period of its useful economic life.
[2] The amortisation of an asset is the gradual elimination of a liability, such as a mortgage, in regular payments over a specified period of time. Such payments must be sufficient to cover both principal and interest.
[3] The UN System of National Accounts (SNA), the basis of accounting standards for the government sector in most countries, is developed on an accrual basis.

The Government's Green Paper *Better Accounting for the Taxpayer's Money: Resource Accounting and Budgeting in Government* (H M Government, 1994a), followed the Chancellor of the Exchequer's announcement in the November 1993 Budget of the Government's decision to introduce resource accounting throughout central government. In it, the Treasury proposed that all central government departments should, from 1999-2000, produce and publish accruals-based 'resource accounts' to supplement their existing cash accounts. For the longer term, the Green Paper also invited views on a move to 'resource budgeting' whereby the Public Expenditure Survey and the Parliamentary Supply process might also be switched to an accruals basis[4].

This was followed by a White Paper in 1995 (H M Government, 1995a), in which Government gave a commitment to use resource accounting as the basis of public expenditure planning and control. The White Paper describes the progress made in developing resource accounting and the Government's proposals to introduce resource budgeting as of 1998. This paper sets out the basis of, and reasons for, the proposed changes and describes some of the issues that have been raised on principles and during implementation.

In 1997, the new Government confirmed its intention to carry the reforms forward. The original timetable was for Government departments to complete (but not audit or publish) resource accounts for the financial year 1997-98. Accounts for 1998-99 would be audited but not published and accounts for the years after that would be published. The first resource-based survey was planned to cover public expenditure in 2001-02 and beyond.

Government confirmed its intention to implement resource accounting in its Economic and Fiscal Strategy Report (*Stability and Investment for the Long Term,* 1998).

The detailed plans were outlined as part of the 1998 Comprehensive Spending Review. Spending plans were to be set to cover the whole public sector, using a new aggregate, Total Managed Expenditure (TME). Expenditure would distinguish between capital and current spending and would be set at a level consistent with the Government's fiscal rules. These rules state that over the economic cycle the Government will borrow only to invest; and that net debt will be held at a stable and prudent level.

As part of the new system, government departments are required to manage separate budgets for capital and current spending. Movement of capital into the current budget is restricted to ensure that the fiscal rules are met and that a short-term pressure on current spending does not compromise longer-term capital investment.

Resource Accounting and Budgeting (RAB) was fully introduced in April 2001. The Minister's commissioning letter for the 2002-06 Strategic Review of Charges set public expenditure limits on a resource accounting basis. It also made clear that we should regard these as maximum limits and that we should demonstrate, by means of a risk analysis, that our advice on charges was consistent with these maximum limits.

4.2.3. The benefits of resource accounting in a public sector context

The principal benefits of resource accounting in a public sector context are the comprehensiveness of the information and the improvements to decision-making that should result.

Accrual accounting should provide a more complete picture of the resources that are being consumed by Government and any future liabilities. This should lead to improvements in decision-making in several ways.

The true cost of policies should be easier to assess. Resource accounting would reflect issues such as opportunity cost (through depreciation and a cost of capital) and potential future liabilities (for example, decommissioning costs). This should ensure that the information to conduct a rigorous cost-benefit analysis would be more readily available. It would also allow a

[4] Resource budgeting is defined as "planning and controlling public expenditure on a resource accounting basis" Andrew Likierman, Head, Government Accounting Service, H M Government.

more objective discussion of the longer-term implications of policy to be discussed, in particular its impact on future generations.

One criticism of resource accounting is that it is less focused on cash and perhaps therefore less consistent with the planning of Government finance where resources come from cash sources: taxes and new borrowing. This criticism overlooks the fact that resource accounting includes a cash flow statement as well as an income and expenditure statement. Government is therefore probably better placed to manage its budget.

A more telling criticism would relate to the costs of implementing resource accounting across Government. The successful implementation of resource accounting would require significant additional experienced accounting resource to be recruited and integrated into government departments. These cost implications would have to be considered seriously since Government policy is rarely driven by considerations of 'profit' or 'loss'. There may be a more cost-effective way to ensure that policy initiatives are subjected to robust assessments of their costs, benefits and long-term implications.

4.2.4. Public expenditure controls

As stated above, the first Strategic Review of Charges, undertaken in 2000, was conducted in a resource environment. This meant that for public corporations, such as the former three water authorities and Scottish Water, public expenditure considered the capital investment made, the profit/loss generated and a capital charge.

For the second *Strategic Review of Charges 2002-06*, public expenditure were modified in relation to public corporations. The modifications were intended to simplify the budgeting rules and, for most public corporations, to align departmental resource budgets and accounts. For Scottish Water, the rules mean that since the *Strategic Review of Charges 2002-06*, the Scottish Executive has scored actual transactions (loans, grants and interest) rather than the capital invested and the profit/loss generated.

4.3 Impact of resource accounting on charges to customers

The introduction of resource accounting did not have a direct impact on the way in which either the three authorities or Scottish Water managed their business or prepared their accounts. The three authorities had always prepared their accounts on an accruals basis. Given that the Scottish Executive wanted the new Scottish Water to be more commercial and better able to resist competition[5], it was reasonable to assume that Scottish Water's accounts would be prepared on an accruals basis. Resource accounting did change the financial control figure that the Scottish Executive used. Instead of monitoring the extent of new borrowing required, (refinancing of existing debt at maturity does not count as public expenditure) the Scottish Executive began to measure consumption of resources and capital spending.

During the early part of 2001, this Office had had an on-going dialogue with the Scottish Executive about the introduction of resource accounting. This continued throughout the summer and early autumn when we were preparing our advice to Ministers. We also participated in a Treasury-led workshop that outlined how the resource accounting based control figures were to be calculated.

Clearly the way in which a company is monitored or analysed does not impact on either its accounts or its underlying business. Consequently, providing that the control total has been correctly adjusted to reflect the difference in how it is calculated, this should have had no impact on the company or the prices that it needs to charge.

Regular dialogue with the Scottish Executive allowed us to be confident that the public expenditure control figures that were included in the letter were consistent with the approach that had been outlined by the Treasury and that they had been adjusted upwards to take account of the difference in the way in which the control figures were calculated.

[5] Sam Galbraith, MSP, the Minister for Environment, Sport and Culture cited these factors in his justification of the creation of Scottish Water in evidence to the Transport and Environment Committee of the Parliament in February 2001.

As such we believe that the introduction of resource accounting controls for the Strategic Review of Charges did not impact either the operation or prices of Scottish Water. Prices could still have been adversely affected in future years if the control figures had resulted in access to borrowing being restricted when it would have been prudent to borrow more.

4.3.1. The calculation of prices in the Strategic Review of Charges 2002-06

In order to analyse the impact of different cost, investment and debt profiles on the charges faced by customers we use a financial model. We arranged for the model for the *Strategic Review of Charges 2002-06* to be audited by Scott Moncrieff, a leading firm of Scottish accountants. The model allowed us to consider a wide range of scenarios and for each we were able to produce an income and expenditure, balance sheet and cash flow statement.

As such, when we were asked to take account of the introduction of resource accounting by the Scottish Executive, it was straightforward to calculate the resources used by Scottish Water (or each of the three authorities). The scope for efficiency in operating and capital expenditure had been identified in the first half of 2001.

In the Review we explained that a sustainable water industry was fundamental to the customer interest. Our advice on revenue caps was designed to place the industry on a sound financial foundation and to balance the financing demands placed on this and future generations. We also recognised that the industry faced a significant efficiency challenge and that there was a risk that the industry may not improve as much or as fast as we would have liked. This would have resulted in a higher level of borrowing. In this context, we were able to use the model to establish an optimum profile for investment.

We conducted a detailed risk analysis to ensure that the limits to public expenditure were not likely to be exceeded. This risk analysis looked at the performance of both the previous authorities and that of all of the companies south of the border. It was clear that the principal risks related to the extent and speed at which Scottish Water (or the three authorities) were able to meet their efficiency targets. There was also a clear risk that future charges could be materially higher if we were to take a very short-term view and borrow to the full extent of the public expenditure limits in order to reduce, somewhat artificially, the level of prices that customers should pay.

We therefore chose to target financial ratios that were consistent with a prudent level of new borrowing. These financial ratios were consistent (given the different capital and ownership structures of the industry) with those agreed with the credit rating agencies by Ofwat. Our explanation of this to the Finance Committee is attached as Appendix 1.

We believe that our caution has been vindicated by events. We now expect that Scottish Water’s total borrowing could increase to almost £2.7 billion by 2006 – principally due to higher than expected capital inflation, the higher cost level inherited from the three authorities and slower progress in meeting the efficiency targets. (The actual level will depend upon how much of the *Quality and Standards II* programme is delivered by April 2006.) This would be some £250-£300 million more than we recommended in our advice to Ministers. While this increase is undesirable from a customer perspective, it has not threatened the prospect of a sustainable water industry. It is therefore clear that customers would have faced even higher charges in the medium to long term had we allowed borrowing to increase at a faster rate than in the *Strategic Review of Charges 2002-06*.

We continue to believe that we advised reasonable revenue caps that were consistent with our duty to promote the customer interest. Subsequent events have shown that sufficient public expenditure had been made available to cover any likely underperformance. The end-year flexibility allowed by the Scottish Executive has also allowed this expenditure to be used when required. We have to conclude, therefore, that the level of public expenditure that was made available by Ministers did not adversely impact customer charges.

4.3.2. The submission of Analytical Consulting Ltd (ACL) to the Scottish Parliament's Finance Committee

ACL submitted a paper to the Finance Committee of the Scottish Parliament. This paper suggested that the move to resource accounting had reduced the borrowing available to Scottish Water and that consequently customer charges were set at too high a level. It also suggested that the Scottish Executive's Annual Expenditure Report for 2003-04 appeared to suggest that more borrowing was available to the industry than the resource limits which were set in the commissioning letter.

The paper's assumption is that it will be in the customer interest to borrow more and pay less in charges. While it is correct to say that in the short run we could potentially reduce charges by increasing the level of borrowing, the long run impact of this on customers must be considered. For example, if we expected the level of annual investment to reduce, it could be useful to increase the proportion of investment funded by debt in the short run in order to maintain a smooth price profile. However, the likelihood is that there will be no significant reduction in the capital programme in the foreseeable future. As such, any delay in increasing prices will simply increase future bills. This is because the extra borrowing can have only one result: to increase the total annual interest payable and set up a repayment liability for future generations. This extra interest will apply every year (unless and until the debt is repaid) and would increase marginally each year to reflect the compounding of interest.

The comparison of the control limits in the commissioning letter and the 2002 Annual Expenditure Report can be explained in a straightforward way. When we were writing the Strategic Review of Charges, it was not certain that the Scottish Executive's proposal to create Scottish Water would be approved by the Parliament.

In contrast, by April 2002, a new Board and senior management team had been appointed. The Scottish Executive knew more about how the integration of the three authorities was progressing and it was also clear that the level of operating costs that would be inherited by Scottish Water was even higher than the three authorities had estimated during the summer of 2001. The Scottish Executive has said that it decided to take an even more prudent view of how much public expenditure may be required and it adjusted its budget baseline accordingly. This increase in public expenditure would not justify an increase in borrowing and a reduction in prices. Indeed, the prospect of significant extra borrowing could threaten the sustainable properly funded industry that the customer deserves. It is important to highlight that no extra value is created for customers as a result of any increase in borrowing beyond the targets set in my Strategic Review of Charges. No new customers will be added to the network, no additional improvements will be made to the environmental and public health performance of the assets and no improved maintenance regime will be introduced (beyond those already funded).

4.3.3. The Scottish Executive's response

The response of the Scottish Executive to the paper prepared by ACL is contained in evidence provided to the Committee by officials and a letter from Allan Wilson, MSP, Deputy Minister for Environment and Rural Affairs.

The Scottish Executive made the following points:

- It is not prudent to borrow more than the value of net new investment.
- The technical treatment of public expenditure in the letter that commissioned the Strategic Review of Charges was correct.
- The change in the method of presenting public expenditure had not reduced the amount of resources available.

Depreciation in the water industry comprises two elements: an infrastructure renewals charge and a 'normal' depreciation charge. The infrastructure renewals charge covers the cost of maintaining the serviceability of the water mains and sewers. While in replacement cost terms these assets represent in excess of 80% of the total asset base, they are not typically included in the asset value included in the balance sheet. The depreciation charge reflects the annual cost of the fixed assets included in the balance sheet. In order to understand the level of net new investment, it is important to deduct both of these depreciation charges.

Net new investment in economic terms may still be overstated even after both depreciation charges have been deducted. This could arise if the asset value on the balance sheet did not include all of the assets that were owned and used by a company, or if the infrastructure renewals charge was set at a level lower in real terms than that required to be spent annually over the very long run. Given the extent of a water and sewerage asset base and that detailed asset registers are a relatively recent development, there is a risk that the depreciation charges do not fully reflect the economic value of the service provided by a water company's assets. A prudent financial strategy would take full account of this risk before deciding what proportion of the accounting value of net new investment should be borrowed.

ACL suggested that it was wrong in the commissioning letter to set a combined control total for 'capital' and 'resources'. As discussed above, the criticism runs that by setting a combined total you 'double count' depreciation and that you therefore reach the public expenditure limit more quickly than would otherwise be the case, thereby limiting the opportunity to borrow money for new assets.

This argument is invalid for two reasons. In section 3.4.1 we discussed that customers could only be disadvantaged if access to borrowing had been restricted and it had been prudent to borrow more. In the Strategic Review of Charges, we took the view that sufficient public expenditure had been made available to cover an appropriate increase in net debt and that the public expenditure limit should not be exceeded on most realistic assessments of the risks facing the industry.

The second reason is technical and relates to the application of resource accounting to a public corporation. The 2000 Spending Review treated 'depreciation' (both the fixed asset depreciation and the infrastructure renewals charge) as a 'non-cash charge' in the resources budget. However, it also counted the 'renewals charge' as a cash item of expenditure within the capital budget. The 'resources' budget was increased to compensate – the external finance limit that had applied to the water authorities (approximately £200 million prior to 2002) was raised to £314 million for 2002-03.

Combining the control targets was designed to protect customers' interests. If a public body makes a bigger surplus than expected, it simply reduces its call on resources from the taxpayer. However, the water industry in Scotland is unusual amongst public bodies because it raises income through charges. If the control targets had not been combined and Scottish Water had made a larger surplus than expected (for example, if it had accelerated its efficiency programme), then this benefit would have accrued to taxpayers and not to customers of the water industry. The combined target allows Scottish Water to keep any surplus and to offset this against its capital expenditure.

4.3.4. The Finance Committee's response to the paper by ACL

We discuss the Finance Committee's Inquiry into the water industry in more detail in Chapter 8. Paragraphs 116 and 117 of the Committee's report explain that the majority of the Committee accepted that the arguments advanced by ACL were incorrect:

"116. Overall, the ACL argument that there is an accounting error is in essence a theoretical one. The Committee received evidence in a letter from the Treasury and from the Executive and the WIC that the ACL interpretation of Treasury advice was wrong and that no double counting took place. The Committee was also told by its Budget Adviser that the ACL claim that the high level of depreciation costs squeezed borrowing levels does not recognise that depreciation is a non-cash charge set in the resource budget, not the borrowing limits. The Committee accepted this advice with Fergus Ewing and Jim Mather dissenting.

117. The Committee was advised that the ACL argument rested on the false assumption that the WIC's advice on a prudent level of borrowing was a limit, when, in fact, the Executive made provision for greater borrowing if it was necessary, ie because of doubts about the attainability of the WIC's efficiency targets. Significant sums of £174 million remain available to Scottish Water for capital investment, over and above the WIC's recommendation of £514 million. The Committee rejected the ACL argument with Fergus Ewing and Jim Mather dissenting."

4.4 Indirect benefits to customers

Prior to 1999, the focus of Government, customer organisations and the industry was primarily on inputs. The industry and customer organisations sought to maximise the public expenditure that was available in order to limit the charges that had to be paid by customers. There was a desire in the industry to keep charges low[6] almost at all costs. While Government increasingly wanted improvements in environmental and public health compliance, it was understandably reluctant to make more public expenditure available if this was not going to result in increased investment and improved environmental compliance. There was a risk that increased public expenditure would have simply delayed price increases.

Public expenditure in the water industry meant a borrowing consent. Increased borrowing means an increase in the higher interest charge. In this context it is important to note that the industry does not actually ever repay the principal of loans, it simply rolls over the principal for another term at the prevailing interest rate. As such this interest charge is paid in perpetuity[7]. This will lead to higher prices for all future customers than would otherwise have been the case.

In our interim Strategic Review of Charges (December 1999), we highlighted that the industry did not seem to be investing sufficiently in the maintenance and refurbishment of its assets. This was important as it meant that debt was being increased at a time when the economic value of the industry's asset base was declining. The *Quality and Standards II* process confirmed our advice that there was insufficient investment in maintenance and refurbishment.

Preparation for the introduction of resource accounting was useful because it switched the focus away from inputs to outcomes – ie how much were we going to invest and for what purpose (maintenance, improvement etc). It also allowed there to be a focus on the costs of service delivery. A sustainable public sector model for the industry required such a change in focus.

Although the Scottish Executive has now reverted back to a public expenditure limit based on access to new debt, the focus has remained on ensuring that sustainable improvements are delivered in environmental and public health compliance and in the value for money provided to customers.

[6] For example, the West of Scotland Water Authority considered that it should maintain average domestic prices at the lowest level in Britain. Such a stance was not consistent either with the higher public health and environmental standards that were required or with the unit cost advantages enjoyed by companies south of the border which supplied more densely populated areas.

[7] There is also a refinancing risk – ie that interest rates may change and that the interest charge faced by customers will change. In the past few years, the industry has benefited from lower interest rates as maturing debt has been refinanced more cheaply; however, most commentators suggest that market interest rates are likely to increase and as such the refinancing risk is less likely to benefit customers in the medium term.

Section 1: Chapter 5
Our monitoring of performance

5.1 Introduction

In Chapter 1 we described our statutory requirement to provide advice to Ministers and explained how this requires the Commissioner to undertake the functions of economic and customer service regulator of Scottish Water. Economic regulation includes the role of performing ongoing monitoring of Scottish Water's economic performance. Similarly, customer service regulation includes ongoing monitoring of Scottish Water's customer service performance.

In Chapter 2 we explained how we set performance targets for Scottish Water as part of the *Strategic Review of Charges 2002-06*. Having set these targets, it is clearly essential that we monitor, and report on, Scottish Water's performance in achieving these targets.

In this chapter we discuss the various mechanisms we use to monitor Scottish Water's performance. We also discuss the importance of performance monitoring for customers.

We believe that our performance monitoring has already brought results for customers. Scottish Water has performed much better in its second year than initial drafts of its business plan suggested would be possible. We are also increasingly focusing on Scottish Water's performance in delivering the £1.8 billion capital investment programme for 2002-06. Clarity on performance in this area will be central to ensuring that customers receive value for money.

5.2 The importance of performance monitoring to the success of a public sector model

In England and Wales, Ofwat monitors and reports on the performance of the companies on a regular basis. Ofwat also sets targets for improvement that are, at least in part, driven by comparisons between the companies. Investors are very interested in these reports because they provide an objective source of information about the prospects of the companies. Also, investor reaction to news from a company could alert Ofwat to an issue that may not yet have surfaced in a regulatory return.

In the public sector model, the absence of investor scrutiny makes our performance monitoring even more important. This explains both our recommendation to the Minister that we should publish annual performance reports and the investment we have put into developing regulatory systems.

Our monitoring has become more rigorous and we will continue to look at ways to improve our understanding of Scottish Water's performance without unduly increasing the amount of information that we request.

5.3 Improvements in performance monitoring

Prior to the creation of the three former water authorities[1] in 1996, only very limited information was available about the performance of the water and waste water industry in Scotland. At the time, water services formed part of the overall responsibilities of local authorities. Integrated budgets meant that financial information, for example on overall levels of investment, was difficult to identify other than at a very high level. Information on customer service provision was also virtually non-existent.

With the formation of the three former water authorities, the amount of information available, and hence the ability to monitor performance, gradually began to improve. However, as described in Chapter 2, there were initially still significant differences between the three authorities concerning the information they reported.

Shortly after the formation of this Office in November 1999, we signalled our intention to establish a mechanism to ensure that it would be possible to carry out rigorous comparisons between the three water authorities and between the industry in Scotland and in England and Wales. The subsequent 'information project' led to the creation of a Scottish version of the

[1] North of Scotland Water Authority, West of Scotland Water Authority and East of Scotland Water Authority.

Ofwat June return. This return provides a comprehensive set of financial, asset condition, capital investment and customer service indicators that allow us to monitor and report on Scottish Water's performance.

In our advice to Ministers contained in the *Strategic Review of Charges 2002-06* we included two key recommendations to strengthen performance monitoring further. This advice was published in November 2001.

i) To endorse a joint project between the Water Industry Commissioner, Scottish Environment Protection Agency and the then proposed (now established) Drinking Water Quality Regulator to ensure that consistent output measures and metrics are collected and monitored.

ii) To require the publication by the Commissioner's Office of annual reports on the performance of the water industry in Scotland. These reports would cover operational costs, delivery of investment and the level of customer service.

We will discuss progress on these two recommendations in more detail below. In summary, the project to identify consistent output measures has proven difficult to implement but the need for such a facility has become increasingly evident. The production of performance reports by the Commissioner is now established, with two Costs and Performance reports, two Investment and Asset Management reports and one Customer Service report already published. These have greatly strengthened the visibility of Scottish Water's progress towards the targets set in the *Strategic Review of Charges 2002-06*, to the benefit of all customers.

We have also built up a range of other performance monitoring activities, which help to improve our understanding of how well Scottish Water is performing. These are covered in more detail below and include the following:

- Monthly financial returns. These financial reports, referred to as RAB Returns, provide a detailed breakdown of Scottish Water's financial performance over the preceding month, as well as progress against annual budgets. These detailed returns allow monthly monitoring of progress against the financial targets set out in the *Strategic Review of Charges 2002-06*.

- Quarterly returns on progress with the capital investment programme. These provide an update on progress, at a project level, in delivering the capital investment programme. They contain information on: forecast and actual project spend, physical progress towards defined milestones, and explanations of financial variances.

- Audits of Scottish Water's investment appraisal process. Investment appraisal is a key activity in determining network investment requirements. Good performance in this area will bring significant benefits to customers.

- Customer service performance audits. These audits provide an assessment of Scottish Water's performance across a range of customer service measures. This allows year-on-year comparisons of performance to be made, as well as comparisons with other benchmark companies.

We believe that monitoring performance is central to regulation. The improvements that have been made in information collection are only valuable if, as a result, customers receive a better level of service or the costs of the industry can be reduced on a sustainable basis. This requires comprehensive and ongoing performance monitoring.

5.4 Information gathering

The collection of robust information on performance is fundamental to performance monitoring. The tools we employ to gather information from Scottish Water have been described in detail in the document, *Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges 2006-10*, published in July 2004. We receive information in a set of 'regulatory returns', which Scottish Water submits to our Office during the year.

In summary, the key returns are as follows:

The Annual Return

This is the largest single information request issued to Scottish Water on an annual basis. It is a comprehensive set of financial, physical and performance indicators. The Return mainly focuses on information relating to the previous financial year, although in some cases it also seeks forward projections.

Each line of information requested has a precise and documented definition. These definitions are provided to Scottish Water in the Annual Return guidance that we issue.

Our Office holds Returns from 1999-2000 onwards for the three former authorities. For 2001-02, Returns were submitted by each of these authorities, followed by a consolidated Return representing collated information for the newly formed Scottish Water. Since 2002-03, Scottish Water has assumed responsibility for submitting a single Return.

The information collected allows us to monitor year-on-year changes in performance and to benchmark Scottish Water's performance with that of the companies south of the border. From 2004 most of the tables from the Annual Return have been available on our website.

Monthly Financial Returns (or 'RAB Returns')

These monthly financial reports contain details of Scottish Water's financial performance over the preceding month and against annual budgets. The accompanying commentary provides explanations for variance against annual targets (in other words, performance above or below targets), and allows areas of concern to be quickly identified.

It is important for us to be able to monitor the financial position of Scottish Water throughout the financial year. The RAB Returns provide visibility on key financial trends and movements in operating costs. We can use the information to report on Scottish Water's progress in achieving its targets.

Capital Investment Returns (CIRs)

The purpose of the quarterly CIR submission is to monitor progress, at a project level, with delivery of the capital investment programme. It contains information on:

- forecast and actual project spend;
- physical progress towards defined milestones; and
- explanations of financial variances.

Through a combination of the quarterly CIRs and the investment tables in the Annual Return, we can track delivery of the investment programme and monitor the effectiveness and efficiency of Scottish Water in delivering the required investment. The CIR can also highlight material changes from the planned investment programme. These may be positive (efficiencies or early delivery of a project) or negative (cost overruns or project delays).

Customer Service Performance Return

This quarterly return provides information about Scottish Water's customer service performance and allows us to check compliance with guaranteed minimum standards of service.

Customer revenue information

These submissions, which are made by Scottish Water twice a year, are intended to capture a wide variety of information about both non-domestic and domestic customers. The information covered includes areas such as customer revenue, consumption and debt analysis. These returns are an invaluable tool in monitoring revenue on an ongoing basis, ensuring that Scottish Water's customer information is consistent with its declared revenues and with the revenue cap set by Ministers.

5.5 Auditing of information

In England and Wales it is water industry practice for Ofwat to use consultant engineers (known as Reporters) to help verify information submissions. The Reporters audit the information provided to the regulator by the companies and highlight any issues or inaccuracies.

Following discussions involving the Scottish Executive, the Commissioner and Scottish Water, a Reporter for the water industry in Scotland was appointed by the Commissioner in December 2003. This will improve the regulatory process in Scotland and provide greater assurance for customers that Scottish Water is being regulated effectively.

In England and Wales the Reporters are funded by the water companies. In Scotland, the Reporter is funded by the Scottish Executive directly, ie by taxpayers.

The regulatory Reporter in Scotland is Mr David Arnell of Black and Veatch Consulting. The Reporter's duties will cover all aspects of Scottish Water's information submissions, as directed by the Commissioner. This will include auditing both the annual regulatory return submitted by Scottish Water and its Business Plan submissions, as well as reviewing the proposed investment programme to ensure that Scottish Water's investment plans are robust. Such scrutiny has played an important role in improving the quality and reliability of information provided to Ofwat by the companies in England and Wales.

5.6 Performance reports

We noted above that the collection of information is only the means to an end. It is important that we use this information to ensure that customers receive a better level of service or that the costs of the industry are sustainably reduced. We can use the information to set more challenging targets or to inform customers and create an expectation of, or a demand for, better value for money. The key to encouraging customers to expect more is the publication of performance reports. These reports are designed to report objectively on Scottish Water's progress in achieving targets. They also allow comparisons to be drawn with the performance of the water companies in England and Wales. We work hard to ensure that these reports can be readily understood.

In accordance with the recommendation to Ministers in the *Strategic Review of Charges 2002-06*, our Office now produces three regular reports on Scottish Water's performance in the areas of:

- costs and performance;
- investment and asset management; and
- customer service.

The Costs and Performance Report provides information on the progress of Scottish Water towards meeting the capital and operating cost efficiency targets set in the *Strategic Review of Charges 2002-06*.

In the most recent *Costs and Performance Report*, published in November 2003, we welcomed the progress that Scottish Water had made in its first year of operation in reducing operating costs by £37 million (nearly 10%) in real terms. However, we also challenged Scottish Water to build on its solid start. We identified in the report that the rate of improvement in efficiency would have to accelerate significantly if increases in customers' bills were to be avoided. Specifically, the report identified that the average domestic customer's bill was £80 higher than it needed to be, based on a comparison of performance with the companies in England and Wales.

The *Investment and Asset Management Report* examines the investment performance of Scottish Water. It also considers at historical investment in the water industry in Scotland and the overall condition and performance of the industry's assets.

The most recent *Investment and Asset Management Report*, published in April 2004, alerted customers to the slow progress that Scottish Water is making in delivering the vital improvements to drinking water quality and the environment, which are included in the £1.8 billion *Quality and Standards II* investment programme. It also confirmed that the condition and performance of the asset base in Scotland is on a par with that in England and Wales and that investment per property is broadly similar both sides of the border.

The *Customer Service Report* examines the trends in service levels provided to customers and gives information on Scottish Water's performance against key measures of customer service.

In the first *Customer Service Report*, published in October 2003, we noted that the level of service provided to customers is still significantly lower than that delivered by the companies in England and Wales.

These reports provide objective analysis of the current performance of the industry in Scotland. While they have highlighted some improvements in Scottish Water's performance, particularly in the quality of its management information and in achieving efficiencies, the overall message has been that significant further scope for improvement remains.

Inevitably, this message can be unpopular with the senior management of Scottish Water and with some other industry stakeholders. However, we believe that the reports provide an objective assessment of Scottish Water's performance. This benefits customers by improving the transparency of the industry's progress in achieving efficiency targets, delivering investment and improving customer service. Sustainable improvement requires a common understanding of where we are and where we need to get to.

Through time, these performance reports will provide an evidence base for improvements that have been achieved and the increase in value for money that customers expect.

5.7 Monitoring the output of investment

As explained above, in the *Strategic Review of Charges 2002-06*, we recommended to Ministers that they should endorse a joint project between the Water Industry Commissioner, Scottish Environment Protection Agency and the then proposed (now established) Drinking Water Quality Regulator. The aim of the project would be to ensure that consistent output measures and metrics are collected and monitored.

The requirement for this project was highlighted in the work carried out for the Review[2]. Defining and monitoring output measures is an essential part of monitoring delivery of the capital investment programme. In the absence of such detailed output measures, we can currently only monitor the *inputs* to the investment programme, such as the delivery of water main and sewer replacement and new water and waste water treatment plants. This is clearly better than nothing. However, if customers are to be sure that they are getting value for money we need to ensure not only that the money was spent (in fact less money spent could be a good thing!) but also that the *outputs* – such as cleaner beaches, better water quality and improved customer service – can be effectively and reliably monitored. This would allow us to comment on the effectiveness of the delivery of the improvements targeted in the Quality and Standards process.

Defining these output measures is not straightforward. We need to be sure that we do not create inappropriate incentives and we must ensure that the outputs cover all areas of the programme. In late 2002, a contract was awarded for work in defining a suitable set of output measures and a stakeholder group was formed to oversee the process. The stakeholder group involved representatives from the Scottish Executive, the Scottish Environment Protection Agency, the Drinking Water Quality Regulator, the Water Industry Commissioner and Scottish Water.

Work progressed during early 2003 but it became clear that the complexity of the task was greater than had initially been envisaged. The project was suspended in

[2] *Strategic Review of Charges 2002-2006,* Section 4: Chapter 19, Page 212.

August 2003 because we had to focus on preparatory work for *Quality and Standards III*. We are disappointed by the lack of progress in this area because we regard the definition of these outputs as an important step forward in improving the quality of investment monitoring. The requirement to complete this work remains. However, until such time as a comprehensive set of output measures are in place, we will continue to monitor the delivery of the investment programme at an 'input' or project level.

5.8 Investment appraisal audits

An essential part of good asset management is the proper appraisal of investment options. During the current regulatory period, Scottish Water is tasked with delivering around £450 million per annum of investment[3]. Customers will want to be assured, through performance monitoring, that Scottish Water has proper investment appraisal processes in place and that the investment programme is being delivered efficiently and effectively.

In the last Strategic Review of Charges, we raised concerns about the level of scrutiny and challenge given by the former authorities to projects as they passed through the project appraisal process. We therefore decided, as part of our performance monitoring role, to carry out regular investment appraisal audits of the authorities to highlight areas of strength and areas that were falling short of best practice.

These audits form an important part of assessing the effectiveness of investment decision-making by Scottish Water. In particular, they assess Scottish Water's relative position compared with previous audits and in relation to industry best practice. The projects audited are selected at random (a mix of large, small, in progress and completed projects). The assessment involves a review of the relevant project documentation and structured interviews with project staff.

We propose to carry out a third investment appraisal audit in December 2004. This will form a key input to the assessment of Scottish Water's asset management performance and the scope for capital efficiencies.

5.9 Customer service audits

The only contact many customers have with Scottish Water is when they are making a complaint or querying an aspect of service. The way in which Scottish Water handles a complaint can have a significant impact on how the company is perceived by its customers. If the contact is handled well this can have a positive impact and will help to restore the customer's confidence in Scottish Water's level of service. If handled poorly, it will compound any negative perceptions.

We carry out quarterly quality performance assessments to monitor how well Scottish Water handles customer complaints. Each quarter, we make a random selection of 100 complaints received by Scottish Water. Each complaint response is reviewed and scored on aspects such as its clarity, completeness, tone and appropriateness. We raise any areas of concern with Scottish Water.

The findings from these performance assessments are reported in our Customer Service Report.

5.10 Future improvements in performance monitoring

As outlined above, performance monitoring in the water industry in Scotland has developed significantly in recent years but there is still room for improvement. We are committed to ensuring that customers get better value for money and to this end intend to work to strengthen our performance monitoring in the area of investment delivery. We will also need to adapt our processes to take account of future changes in legislation and in the regulatory framework, such as the introduction of a framework for competition and the development of regulatory accounts. In the following section we discuss how we see performance monitoring developing in the future.

3 Investment delivery is currently running at around £400 million per year.

Our performance monitoring serves three main functions:

- It provides the information we use to advise Ministers on progress towards the targets set out in the *Strategic Review of Charges 2002-06*.
- It provides us with information that allows us to set new, more demanding targets for the industry.
- It allows us to inform customers about Scottish Water's performance in achieving efficiencies, delivering investment and improving customer services.

Advances in performance monitoring and reporting have brought a level of clarity to the performance of the Scottish water industry that has not previously existed. In particular, the comparison of performance levels with England and Wales has brought into sharp contrast the work that remains to be done to achieve the levels of efficiency and customer service that are being achieved south of the border. Perhaps inevitably, this has led to accusations of unfair comparisons and criticisms of our methods of calculation.

For comparisons to be fair, it is essential that the information we collect is accurate and that the analysis we carry out is as robust as possible. This is fundamental to the success of regulation. We therefore place great emphasis on the quality of the information provided by Scottish Water and on the rigour of our analysis. In particular, we look to ensure that the comparative analysis that we carry out between the performance of Scottish Water and the water companies in England and Wales is sound and fair.

Performance analysis will be less effective if the information that underpins the analysis is disputed. Such disputes are more likely when regulation is relatively new or when the performance gap that is assessed is particularly large. Following publication of the first Costs and Performance and Investment and Asset Management reports in February and March 2003, Scottish Water raised a large number of questions about: our assessment of their efficiency performance; the accuracy of information submissions; and the adjustments we make to their regulatory submissions to ensure accurate comparisons between years and between companies.

It was clear that we needed to work with Scottish Water to understand their objections and, if necessary, revise their efficiency targets. During the spring and early summer of 2003 we worked with Scottish Water and the Scottish Executive to agree a 'Ten principles' document[4]. This agreement sets out a range of measures to ensure clarity on the efficiency targets set for Scottish Water, to improve the quality of information flows and to clarify the nature and scope of adjustments that are made for the purposes of regulatory comparison. These ten principles are described in detail in the next chapter. They provide a number of key improvements to the performance monitoring function by:

- providing clarity on the targets for operating costs and debt for the current regulatory period;
- promoting the appointment of a Reporter of regulatory information to improve information submissions;
- providing a framework for the audit of the regulatory adjustments required to Scottish Water's accounts and regulatory returns; and
- calling on Scottish Water to engage with the Commissioner in improving the quality of data supplied to the Commissioner.

These measures are already producing tangible improvements in our ability to monitor Scottish Water's performance. The appointment of a Reporter, for example, has significantly increased the scrutiny of information submissions. This brings benefits to customers by providing independent verification of the information on which our analysis is based. Similarly, clarity on the financial targets, which Scottish Water is tasked with achieving, brings benefits to all stakeholders.

[4] Letter from the Minister for Environment and Rural Development, Ross Finnie MSP, to the Water Industry Commissioner for Scotland, Alan Sutherland, dated 31 July 2003.

Going forward, the key areas of regulatory activity that will lead to further improvements in performance monitoring are as follows:

- Introduction of regulatory accounts

  The *Strategic Review of Charges 2006-10* will focus only on the core activities of Scottish Water in providing water and sewerage services to customers in Scotland. This change reflects the requirements of the Water Industry Act 2002, which restricts our role to promoting the interests of customers of the core business. As part of this 'ring fencing', we have begun to establish regulatory accounts, which will ensure that customers of the core business are only paying for services associated with core activities. This work will be completed during the current financial year.

- The introduction of a framework for competition in the water industry in Scotland

  The proposed changes to the competition framework contained in the Water Services etc (Scotland) Bill will also require a further level of accounting separation. This framework will require there to be a clear split between the retail (customer service and billing) costs and the wholesale (network management and operation of treatment plants) costs.

Both of these developments will improve the quality of information provision and hence the robustness of our analysis.

5.11 Conclusions

Performance monitoring is fundamental to regulation and brings significant benefits for customers and stakeholders. To withstand challenge successfully, it relies on robust information and sound analysis. Over the past few years performance monitoring of the water industry in Scotland has been significantly enhanced:

- Major improvements have been made in information gathering, with the introduction of the Annual Return submission, monthly RAB submissions, quarterly CIRs and customer service returns and customer revenue information.

- The introduction of a regulatory Reporter for Scotland has greatly enhanced the degree of scrutiny of the information contained within these returns.

- Publication of regular reports on Costs and Performance, Investment and Asset Management and Customer Service have brought a new level of transparency to Scottish Water's performance.

- The development of the 'Ten principles' has clarified targets, improved information collection and set a baseline for performance monitoring.

We will continue to promote further advances in performance monitoring. We hope that our performance reporting and monitoring will act both to create an expectation of improved performance and to inform the future setting of targets. Both will be essential to the success of a public sector model for the water industry.

Section 1: Chapter 6
The ten principles

6.1 Introduction

In the previous chapter, we described our role in monitoring the performance of Scottish Water and the benefits that this brings for customers. We outlined the processes that we use and the improvements that have been made in our performance monitoring activities in recent years. We identified that monitoring and reporting on performance is a key element of the regulatory process.

Successful performance monitoring, and hence successful regulation, relies on the existence of an agreed set of targets which the regulated company (in this case Scottish Water) is required to achieve. Without agreement on these targets, performance monitoring and reporting becomes difficult and regulation will not be effective. This impacts directly on customers and stakeholders as it is the existence of clear targets that drives regulated companies to tackle inefficiencies, deliver investment and achieve customer service improvements.

In this chapter we discuss the process by which we, along with the Scottish Executive and Scottish Water, have worked to improve the clarity of the targets set for Scottish Water in the current regulatory period. Specifically, we discuss the events leading up to the development of the 'Ten principles' which are written terms of understanding between the Scottish Executive, the Commissioner and Scottish Water. We will explain what the ten principles are, why they were introduced, and the impact that they have had to date.

6.2 Targets set in the Strategic Review of Charges

In the *Strategic Review of Charges 2002-06* the Commissioner provided advice to Ministers on the revenue limits that should be placed on Scottish Water for the Review period. In the foreword to the Review the Commissioner commented that[1]:

> "the Review seeks to address the customer's need for a sustainable Scottish water industry. It recommends a revenue cap that should place the industry on a sound financial foundation, where there will be a balance between the financing demands placed on this and future generations."

The advice in the Review establishes a financing regime that is capable of meeting the ongoing costs of investment over the next and subsequent generations. This regime was fully consistent with the requirement, set out in the commissioning letter for the Review from the Minister, that public expenditure limits outlined in the commissioning letter should be regarded as absolute and as the maximum limits. This effectively sets Scottish Water's allowed levels of debt at the end of the Strategic Review period.

The financial framework set out in the Review allows environmental improvements, public health standards and asset replacement needs to be met as and when they fall due. Importantly, the framework is capable of withstanding future shocks, whether caused by increasing interest rates, lower public expenditure, asset failure or more demanding legislative standards.

Following the publication of the Review, the operating cost targets were reviewed by the Transport and Environment Committee of the Scottish Parliament. The committee heard evidence from the three former water authorities and from the Scottish Executive, all of whom regarded the targets set out in the Review as achievable. It also heard from a range of other stakeholders, who did not express a view, and from the unions represented in the water industry. The unions regarded both the method of benchmarking and the resulting targets as unreasonable. After a long and detailed inquiry, the committee concluded that the targets were challenging but fair.

The importance of the targets was confirmed in late September 2001 by the Minister for Environment and Rural Affairs, Ross Finnie, MSP who stated that

[1] *Strategic Review of Charges 2002-06*, published in November 2001. Foreword.

"efficiency savings are essential to ensure that future charge rises for the customer are minimised".

In finalising the Review, and in the period since, the targets set have been subject to intense scrutiny by a wide range of consultants and industry stakeholders. No substantive evidence has been provided which would justify any deviation from the agreed targets. We therefore continue to believe that the targets which underpin the Strategic Review are consistent with proper and rigorous analysis and that a well-managed company should be able to achieve, if not beat, the targets comfortably. This is in the interests of all customers.

6.3 Scottish Water's business plan

The *Strategic Review of Charges 2002-06*, published in November 2001, provided advice on revenue caps for both the three authorities and the proposed Scottish Water. The Review therefore established the regulatory targets for Scottish Water in the period to 2006.

At the current time, Scottish Ministers can change the level of borrowing that is available to Scottish Water. They cannot, however, alter the cap on revenue without seeking further advice from this Office. Scottish Water is required to produce an annual business plan for approval by Ministers which sets out the Board's strategic aims for the company and contains details of the key financial and delivery targets for the business.

In early 2003, Scottish Water provided the Minister for Environment and Rural Development, Ross Finnie, MSP, with its proposed business plan for the three-year period from 2003-04 to 2005-06. In March 2003, the Minister wrote to the Commissioner asking him to consider representations from Scottish Water about its strategic business plan. In particular, the Minister noted that Scottish Water's proposed business plan suggested that Scottish Water's operating cost targets would be different from those set out in the Strategic Review of Charges. This would have resulted in increased borrowing, no extra benefits for customers and increases in future charges.

As requested by the Minister, we began a dialogue with Scottish Water on the contents of its proposed business plan in early April 2003. During this process we made it clear to Scottish Water that any change to the targets set out in the Strategic Review of Charges would require an analytically sound justification and would need to identify factors which were:

- unique either to Scottish Water or to a subset of the companies regulated by Ofwat (which were used as benchmark companies in the Strategic Review);
- not within the management control of Scottish Water;
- new, ie not known in October 2001 when the *Strategic Review of Charges 2006-10* was carried out.

We suggested to Scottish Water that one area for discussion would be the starting position inherited by Scottish Water in April 2002. We had already commented, in the *Costs and Performance Report 2001-02*, that the performance of the three former authorities on underlying operating expenditure was some £20 million above the assumptions in the Strategic Review of Charges.

We received written representations from Scottish Water on its proposed business plan on 14 April, 25 April and 15 May 2003. We also met with Scottish Water to discuss these representations on 17 April and 2 May 2003. We considered these representations in detail to establish whether, based on the criteria outlined above, they would justify any changes to the targets set out in the Strategic Review of Charges.

On 27 May 2003 we responded to the Minister for the Environment and Rural Development with a detailed analysis of Scottish Water's representations and their impact on the assumptions that underpin the Strategic Review of Charges.

In our response we pointed out that the operating cost projections contained in Scottish Water's strategic business plan would have led to price increases of around £40-£50 for the average domestic customer in 2006-07. We explained that we considered this to be neither justifiable nor acceptable. We also concluded that Scottish Water's business plan did not provide a sufficient degree of financial sustainability to ensure the longer term success of the company. This is clearly not in customers' interests.

As well as analysing in detail the representations that Scottish Water made about its strategic business plan, we also took the opportunity to review the assumptions and the risk analysis that underpinned the *Strategic Review of Charges 2002-06*. We concluded that some minor changes would, in the light of our knowledge now, have been made, but that none of these either collectively or individually would have caused a material change to this Office's advice on either the revenue caps or the efficiency targets.

We identified one small variance in favour of Scottish Water. This arises from a difference in the definition of a public sewer between the law in Scotland and that in England and Wales. In Scotland, the section of the sewer which runs from the sewer main in the street to the curtilage of the property is the responsibility of Scottish Water. In England and Wales the entire service connection from the sewer main into the property is the responsibility of the customer. This would have reduced the assessed efficiency gap between Scotland and England and Wales by just over £2 million per year.

Scottish Water representations

Scottish Water made representations on a number of other issues. However, our analysis has shown that none of these issues justifies any variance away from the recommendations contained in the Strategic Review. Each of these issues is considered below:

- **Bad debt:** Scottish Water claimed to be disadvantaged by its relatively high level of domestic bad debt. Our analysis showed that Scottish Water is a considerable net beneficiary (by around £20 million) from the agreement with local authorities to collect domestic charges. It would therefore not be appropriate to cite a worse bad debt position as a reason for failing to close the efficiency gap.

- **Non-core costs:** Scottish Water excluded 'non-core' costs from its presentation of its operating costs in the strategic business plan. The Strategic Review of Charges funded in full all 'non-core' activities that were conducted by the three authorities in 2001. In order to ensure a like-for-like comparison of Scottish Water's performance with the targets set in the Strategic Review, these costs needed to be added back. This increases declared cost levels in the strategic business plan by around £11 million, to £12 million per year.

- **Capitalised operating costs:** Scottish Water increased the amount of operating cost capitalised both in proportion to revenue and to the size of its capital programme. The presentation of information or a change in the implementation of an accounting standard should not be allowed to impact on the assessed performance of a company. The increases in capitalisation projected by Scottish Water did not appear to be consistent with the practice of companies in England and Wales. As a consequence, and in the absence of much greater clarity on the capital programme, it is appropriate to reverse this change to ensure a truer comparison. This increases the stated operating costs in Scottish Water's plan by some £40 million over four years.

- **PFI costs:** In the Strategic Review of Charges we accepted the former authorities' estimates of the costs associated with PFI (Private Finance Initiative) schemes and did not seek to include an efficiency target for PFI. The strategic business plan forecast that PFI spending would be higher. This resulted from a reallocation of operating expenditure. Again, in order to ensure a like-for-like comparison, stated operating costs had to be increased by around £3 million a year.

- **Pace of change and associated risk:** We analysed this issue in detail in the Strategic Review[2] and there was no new evidence that was not considered in detail at that time.

- **Effectiveness of the transition team:** Scottish Water stated that slow progress in its first year was inevitable because the transition team was not fully effective. This claim did not bear scrutiny because:

  - many critical organisational and strategic decisions were taken in advance of the legal establishment of Scottish Water; and

  - many of the senior managers of Scottish Water were closely involved in the transition process.

  We could not see any valid justification to blame the transition arrangements for the lack of progress made in the first year of Scottish Water.

- **Level of service to customers:** Scottish Water is proposing a customer focused strategy. There was no evidence that its proposals would result in higher costs. It is likely that customer service in 2005-06 will be broadly similar to that offered by the privatised companies. This did not seem to justify any change in targets.

- **New operating expenditure:** In its strategic business plan, Scottish Water raised concerns regarding funding the operating costs of newly installed treatment works in 2001-02. The allowances made available in the Strategic Review of Charges should be more than adequate to cover any additional operating expenditure.

- **Costs of meeting tight consent standards for effluent discharges:** Scottish Water claimed[3] that consents set by the Scottish Environment Protection Agency provide a higher level of environmental protection than those issued to the English sewerage companies by the Environment Agency. This argument had little merit. Even if it could be proved that compliance standards in Scotland were more demanding, current actual discharge compliance levels in Scotland, relative to those in England and Wales, are poor. Until the levels of compliance are comparable, there would seem to be no possible case for additional revenue. Moreover, Scottish Water currently benefits from the comparison with England as the operating costs allowed reflect the much greater compliance currently achieved in England.

- **Staffing issues:** Scottish Water has claimed that it is unduly constrained by its inability to use compulsory redundancy. This claim was without merit. It is up to management to decide on an appropriate level of employment and an appropriate per capita cost. The experience south of the border (where both staffing levels and average salaries vary widely) has shown that these issues can be managed successfully, even without the 'spend-to-save' funding that was made available in the Review. Such funding is not allowed to the privatised companies.

- **Asset quality:** Scottish Water has estimated that the additional costs associated with running its large number of small assets may be from £10 million to £40 million higher than an equivalent company south of the border. Our Office's econometric models estimate the extra efficient cost incurred by Scottish Water because of its large number of small assets is some £18 million. This was taken into account in the efficiency targets set in the Strategic Review of Charges. This is equivalent to around £30 million at Scottish Water's level of efficiency at the time. There also appeared to be no material factors relating either to the level of investment or to the condition of assets that put Scottish Water at a disadvantage relative to the comparator companies.

- **Levels of inherited leakage:** Scottish Water states that its relative operating cost performance suffers from its high levels of inherited leakage. After detailed analysis, we concluded that Scottish Water

[2] *Strategic Review of Charges 2002-06*, page 194.
[3] Explanatory Submission, 25 April 2003, page 22.

actually benefits from comparison with the companies south of the border since Scottish Water is not currently required to meet the costs of reducing leakage.

- **Capital expenditure inflation:** Scottish Water asserted that it needed more money to meet increased capital costs due to inflation in capital works. In the Strategic Review of Charges, we estimated both capital expenditure inflation (COPI) and Retail Price Inflation (RPI). As with most forecasts of inflation, both estimates have turned out to be inaccurate. The estimate of COPI proved, at that point in the period, to be too low and the estimate of RPI too high. If the estimates were to be correct for the remainder of the regulatory period, Scottish Water would benefit by a net £70 million. If COPI continues at its current rate and RPI reverts back up to 2.5%, then Scottish Water may suffer to the tune of up to £24 million. We considered that delivery of outputs to customers would not be materially affected by these potential variances.

- **Property disposals:** Scottish Water claimed that the target for property disposals in the Review was unreasonable. We believed that the estimate of the potential total proceeds from property disposals was reasonable. The estimate implied a rate of sale that was less than had been achieved south of the border each year since privatisation in 1989. Although Scottish Water did not quite reach this level in its first year, the three authorities achieved higher levels in their final year. We also noted that Scottish Water reported the closure of only 1 of 39 offices and 1 of 96 depots in 2002-03 (the first year of the Review), yet still came close to reaching the target in the Strategic Review of Charges.

Risks

The Minister's letter also asked about the risks facing Scottish Water. It is important to distinguish between the specific risks that relate to the normal operation of a water and sewerage company and the systematic risks that are not directly within the control of management. Customers have a right to expect that the specific risks of providing a water and sewerage service will be managed effectively.

The elements of systematic risks that need to be considered by owners relate to the primary function of ownership. In the privatised system, owners wish to maximise their return on investment. In the public sector model, Government wants best value for money for customers and to ensure that policy priorities (social, environmental and public health) are delivered. The Scottish Executive can only minimise the risks to the public sector model by achieving the right balance between price to customers and the level of service. Customers are increasingly making their voices heard on the issue of value for money[4] and this issue is being taken up by the media to an increasing extent.

If customers begin to believe that they are not getting value for money then the public sector model for the water industry in Scotland may not be sustainable without radical action. The greater the extent of perceived failure, the more difficult, painful and costly may be the corrective actions required.

It is important to recognise that managers will always benefit from the asymmetry between their knowledge and experience and that of the customer, regulator or owner. In any large portfolio of assets (both human and physical), there are likely to be both poor and good performers. More information about poor performing assets may change our perception of risk, but it does not change the overall risk faced by the business. The overall risk faced by the business depends on the level of historic maintenance of the assets, the resources available and the quality of management.

Analysis has shown[5] that investment spending per household will have been broadly the same in Scotland and in England and Wales in the period 1989 to 2006. Moreover, it appears that the condition of assets in Scotland is no worse than that south of the border.

[4] We received 800 telephone and 100 written complaints in the period mid-March to end April 2003. This compares with 351 telephone and written complaints in the whole of 2001-02.
[5] *Investment and Asset Management Report 2000-03.*

A regulatory settlement seeks to provide sufficient resources such that a good management can deliver the level of service expected by customers on a sustainable basis. Ofwat has more than 14 years experience in monitoring the delivery of an improving water and sewerage service. Its methods have survived rigorous challenge. Our analysis shows that had Ofwat conducted the *Strategic Review of Charges 2002-06*, Scottish Water would have faced much more challenging efficiency targets and would not have received the spend to save allowance. Under that scenario, Scottish Water would have received some £500 million less than was allowed by the revenue cap in the Review.

To put this in perspective, if the same public expenditure had been used, average bills to customers could have been some 12% lower. This would have reduced the amount payable by the average household by some £125 over four years. This contrasts sharply with the further increases in customer bills that would be required in Scotland if Scottish Water's proposed business plan was implemented and the recommendations as set out in the Strategic Review were not followed. It should be noted, however, that such challenging efficiency targets would have been extremely difficult to achieve and, in our judgement, not in the customer interest.

It is also the case that the companies in England and Wales are required to deliver a markedly higher level of service to customers (for example in their levels of leakage and responses to billing enquiries) than is currently provided in Scotland.

We considered in particular detail the rate at which Scottish Water had been asked to improve. We reviewed all of the evidence and concluded that the performance improvement required of Scottish Water was less than that achieved by the worst performing company in England and Wales during the mid and late 1990s. The target appeared more challenging because of the spend to save allowance that was made available to management in Scotland as part of the Strategic Review of Charges. This is a considerable relative benefit because the privatised companies have to rely either on outperformance of more challenging regulatory targets or on shareholders' funds to meet any up-front reorganisation costs.

Conclusions of our review of Scottish Water's representations

Our response of 27 May 2003 concluded that if the management of Scottish Water performed at broadly the same level as the management of the companies south of the border, then there was no reason why the targets set in the Strategic Review of Charges should not, as a minimum, be achieved.

In the foreword we commented that the most desirable outcome from a customer perspective was for Scottish Water to deliver the efficiency targets and the level of service that were set out in the *Strategic Review of Charges 2002-06*. To do so would, however, require urgent management attention to address the following concerns:

- the level of some operating costs;
- the delivery of capital investment;
- the lack of information about the customer base; and
- the distraction represented by non-core activities.

We also commented that there was a requirement for a significant further strengthening of the regulatory framework.

We noted that customers would only benefit when the management of a monopoly utility is faced with clear and tight constraints on its budget and outputs. Regulation has a vital role to play in ensuring this happens – but it needs the support of the owners to operate properly. Experience from south of the border has shown that regulated utilities are capable of making significant efficiencies while improving levels of service.

6.4 The ten principles

Following our response of 27 May 2003 to the Minister for Environment and Rural Development on Scottish Water's representations on its business plan, the Scottish Executive, Scottish Water and this Office discussed how best to proceed.

In his letter of 25 March 2003, the Minister had made clear that he wanted an agreed set of financial targets for Scottish Water going forward. It was also our belief that clear targets are part of a robust regulatory framework and should provide customers and stakeholders with an assurance that the required efficiency, environmental and customer service improvements are being achieved.

We discussed the following issues:

- Differences in understanding between ourselves and Scottish Water on the calculation of its operating costs; specifically, the mechanism for making regulatory adjustments to Scottish Water's accounts to ensure accurate comparisons between years and between companies.
- The difference between Scottish Water's business plan estimates of its operating costs and the targets set out in the Strategic Review of Charges.
- Scottish Water's allowed level of debt at the end of the Strategic Review period and the associated impact of projected price inflation in the cost of capital goods.
- The treatment of over-collection and under-collection of revenue.
- Mechanisms for improving the regulatory process, particularly the quality of information.
- Methods for assessing the efficiency of Scottish Water.
- Improvements in the working relationship between Scottish Water and our Office.
- The treatment of non-core activities.
- Establishing a 'right of appeal' for future Strategic Reviews.

We had to find a settlement that protected the customer interest but that would also be acceptable to Scottish Water. Agreement was reached in July 2003 and on 31 July the Minister for Environment and Rural Development, Ross Finnie, MSP, wrote to us to set out the following Ten Principles of agreement:

Principle 1

Operating costs for the whole year 2005-06 should be at a maximum of £265 million, which is £7 million above the £258 million WIC monitoring target set in the Strategic Review. The £7 million allows for factors that were unknown at the time of the Review and comprises £4 million additional allowance for the higher operating costs position inherited by Scottish Water and £3 million for the different legal status of lateral sewers in Scotland. This will provide a significant protection for customers against future unnecessary price increases. In reporting the operating cost performance of Scottish Water, the Commissioner will comment upon progress towards this figure.

This principle sets out a clear target for operating costs at the end of the regulatory period. This is consistent with the target set in the Strategic Review of Charges. The small increase of £7 million is justified for the following reasons:

- Scottish Water inherited a worse than expected starting position in April 2002. We had already commented, in the *Costs and Performance Report 2001-02*, that the performance of the three former authorities on underlying operating expenditure was some £20 million above the level we assessed in the Strategic Review of Charges. Analysis had shown that Scottish Water should be capable of closing 80% of its efficiency gap, which reduces this impact to £16 million. This implied that an upward adjustment of £4 million per year was appropriate. There was a difference in the definition of a public

- sewer between the law in Scotland and that in England and Wales. In Scotland, the section of the sewer that runs from the sewer main in the street to the curtilage of the property is the responsibility of Scottish Water. In England and Wales the entire service connection from the sewer main into the property is the responsibility of the customer. This would have reduced the assessed efficiency gap between Scotland and England and Wales by just over £2 million per year.

Inflation increases the total impact of these two factors to £7 million.

This first principle established an agreed target for operating costs. This is fundamental to effective regulation and performance monitoring. Customers could still look forward to a significant improvement in the industry's efficiency.

Principle 2

Scottish Water's total debt at the end of the Strategic Review period may rise to a maximum of £2.47 billion. This level of debt includes an amount of up to £112 million reflecting estimates of projected price inflation (above 1.5%) in the cost of capital goods. The range will increase to a maximum of £2.71 billion when the remaining £235.2 million (post-efficiency, £305.5 million pre-efficiency) of 'red' projects in the WIC 18 capital investment programme are approved by all stakeholders for inclusion in the programme.

This level of debt is higher than we had targeted in the Strategic Review of Charges. In the Review we had suggested a level of debt of £2.4 billion in 2005-06.

In our Strategic Review, we had sought to place the industry on a sound financial foundation, with a balance between the financing demands placed on this and future generations. Prudent use of debt made the industry better able to absorb the 'shock' of underperformance against efficiency targets and higher capital inflation. In the public sector, debt is funded through increased public expenditure. Increased levels of debt therefore disadvantage customers in two ways:

- interest is payable since the public expenditure comes in the form of a borrowing consent; and
- the significant opportunity cost of other public services is foregone.

We remain of the view that the likely outturn for debt is consistent with the sustainability of the industry in the long term and still offers some protection from unexpected shocks (eg higher interest rates). This means that the interest payments resulting from borrowing now should not impose an excessive burden on future customers through higher charges.

Scottish Water correctly indicated in its representations that capital inflation had run at a considerably higher level than we forecast at the time of the Strategic Review of Charges. Normal regulatory practice is that ex ante estimates of inflation are corrected at the time of the next Review – unless the impact is exceptional and threatens the delivery of agreed outputs.

I had assessed the impact of this higher capital inflation on Scottish Water. Up to that point the extra cost required to be met by Scottish Water was £21 million. If capital inflation had continued to run at those levels, this extra cost could have increased to £115 million. We continue to monitor capital inflation.

Principle 3

Scottish Water and the Commissioner will agree schemes of charges for both 2004-05 and 2005-06 in the near future, in such a way as to include price caps that are consistent with the revenue caps agreed in the Strategic Review. The purpose of this provision is to provide customers with a greater measure of certainty about their forthcoming bill. In addition, Scottish Water and the Commissioner will establish a mechanism to adjust future schemes of charges for over-collection and under-collection of revenue.

This principle is largely self explanatory. We have a statutory duty to consider and, where acceptable, approve Scottish Water's annual scheme of charges. This scheme of charges sets out the tariffs for all of the core services offered by Scottish Water[6]. Under this scheme there is always likely to be over or under recovery of revenue. Customers' interests are protected by ensuring that such over or under recovery is taken into account in future years.

Principle 4

A Reporter of regulatory information will be appointed as soon as practicable. The Reporter will operate in a fashion similar to Reporters in England and Wales. The Reporter should be appointed by the Commissioner and would be chosen from amongst persons that have served at least three years as an Ofwat-named Reporter. The Executive will meet the cost of the Reporter.

In England and Wales it is water industry practice for Ofwat to use consultant engineers (known as Reporters) to audit regulatory returns. The Reporter audits the information provided to the regulator by the companies and highlights any issues or inaccuracies.

We appointed a Reporter for the water industry in Scotland in December 2003. This has already improved the regulatory process in Scotland and will ensure that customers can have confidence that Scottish Water is subject to effective regulation.

In England and Wales the water companies pay for their Reporter. In Scotland, the Scottish Executive is meeting the cost of the Reporter from public expenditure.

The Reporter's duties cover all aspects of Scottish Water's regulatory returns. This will include auditing the annual regulatory return submitted by Scottish Water, its business plan submissions, and reviewing Scottish Water's proposed investment programme. Such scrutiny has played an important role in improving the quality and reliability of information provided to Ofwat by the companies in England and Wales.

Principle 5

Measurement of Scottish Water's comparative and improving efficiency will take place on the basis of the method established in the Strategic Review of Charges. Appropriate costs (subject to audit by the Auditor General) incurred in the pursuit of activities not undertaken in 2000-01 will be removed from regulatory operating expenditure to the extent that these costs are funded by revenues from these new activities.

This links closely with Principle 6 below. Consistency and comparability of information between years is essential to the regulatory process. We need to compare like-for-like if our performance reports are to be objective. It follows that if the accounting rules used by Scottish Water change between years, then the financial information provided to us must be adjusted to ensure that it can be compared on a like-for-like basis.

Our analysis of Scottish Water's business plan highlighted the importance of ensuring that Scottish Water is fully aware of how we adjust costs for regulatory purposes. We are keen that Scottish Water understands the reason for each adjustment to the accounting information provided to us.

Principle 6

Subject to the agreement of the Auditor General, the Commissioner and the Auditor General for Scotland will work closely to establish the nature of prospective regulatory adjustments, prior to the Auditor General commencing audit of Scottish Water's accounts. It is intended that the broad nature of forthcoming regulatory adjustments may be set out in a note in the accounts in addition to (but not substituting) information contained within the existing accounting requirements. The Commissioner will request that the Auditor General for Scotland audit the process by which the Commissioner

[6] Except trade effluent.

makes adjustments to information contained within the accounts and regulatory return made by Scottish Water to the Commissioner. After consulting the Commissioner and Scottish Water, the Executive will seek the views of the Director General of Ofwat on the nature and scope of adjustments that should normally be made to audited accounts for purposes of regulatory comparison.

This links to Principle 5 above. In order to provide transparency to the process of making regulatory adjustments to the information contained within Scottish Water's accounts, the Auditor General for Scotland[7] will audit the process. The Scottish Executive will also consult with Ofwat on the equivalent process in England and Wales. This will provide assurance to customers and stakeholders that the regulatory adjustments made are robust and appropriate.

Principle 7

Scottish Water will agree to work with the Commissioner to put in place a range of measures to assist the improvement in their relationship. This is likely to include various matters, including for example, the sharing of reports prior to publication (for the purposes of factual comment), the provision of regulatory and other information to the media, and other mutual mechanisms for resolving routine working issues as they arise.

In his letter of 25 March 2003, the Minister for Environment and Rural Development, Ross Finnie, MSP, had expressed disappointment that our Office and Scottish Water could not agree performance targets.

We accept that the relationship was not ideal but would note that managers of monopoly utilities are not likely to welcome regulation nor consider it fair. It is not the regulator's duty to criticise or to argue with the regulated company, but to establish a framework which ensures that customers receive, on a sustainable basis, the best possible value for money. It is therefore our policy to maintain a professional, objective approach in our dealings with Scottish Water. It is perhaps inevitable that tensions will arise from time to time.

The measures outlined in this principle aimed to increase communication between our Office and Scottish Water. In particular, it was hoped that providing Scottish Water with an advance copy of performance reports would be helpful in reducing tensions. There has been a marked improvement in the relationship between Scottish Water and this Office. However, we will continue to criticise Scottish Water where we perceive that customers are not receiving the cost savings or standards of service they deserve.

Principle 8

Non-core activities that are new in nature or additional in extent to those passed to Scottish Water by the former Authorities may be pursued by Scottish Water (subject to the approval of Scottish Ministers) on the basis that they are funded by performance in excess of the agreed minima, taking into account progress towards the target for the end of the period.

We have stressed the importance of Scottish Water focussing on its core business. We believe that non-core activity is, at best, a distraction of management time for uncertain returns and, at worst, a potential waste of customer revenue. We remain of the view that customers of the core business should be fully protected from the potential risks of non-core activity. This would be best achieved by a robust and transparent ring fence of the core activities of Scottish Water.

In the forthcoming Strategic Review of Charges we will be able to focus solely on the core activities of Scottish Water. This change reflects the provisions of the Water Industry Act 2002. This Act restricted our role to promoting the interests of customers of the core business. As part of this ring fence, we have begun to establish regulatory accounts. These will ensure that customers of the core business pay only for core services. This work will be completed during the current financial year.

This principle allows Scottish Water to continue to pursue non-core activity but sets a clear framework that limits the potential impact on customers of the core business.

[7] The Auditor General is appointed by the Crown, is independent and reports to the Scottish Parliament. His role is to examine how public bodies spend public money, to ensure that they manage their finances to the highest standards and that they achieve value for money.

Principle 9

The Executive will investigate setting up a prospective appeal mechanism to the Competition Commission.

The 2002 Act requires us to provide advice to Ministers in a Strategic Review of Charges. This advice should cover the factors to be taken into account or left out of account in the setting of charges. It is then up to Ministers to decide an appropriate level of funding for the industry. There is no formal appeal mechanism for Scottish Water.

In announcing the proposals outlined in the draft Water Services etc (Scotland) Bill, the Minister indicated his intention to create a Water Industry Commission and to provide it with powers to take decisions about prices within a guidance framework provided by Ministers. This effectively means that the Commission will mirror the role of other utility regulators in the UK. Scottish Water will have a right of appeal to the UK Competition Commission. Again, this is consistent with other utility regulation models.

We welcomed this proposal. It ensures that challenges to regulatory decisions can be assessed in an objective and independent way. It will also help reinforce the requirement on our Office to ensure that regulatory decisions are consistent with the recommendations of the Better Regulation Task Force, ie that they are transparent, accountable, consistent, targeted and proportionate.

Principle 10

Scottish Water will engage with the Commissioner in improving the quality of data supplied to the Commissioner.

Information is vital to effective economic and customer service regulation. Scottish Water is required to provide us with a wide range of information, covering all aspects of its water and waste water business. This information allows us to monitor and report on Scottish Water's performance and to make comparisons with other service providers, particularly the water and sewerage companies in England and Wales. It is therefore essential that the information we receive from Scottish Water is appropriate, accurate and timely.

Specifically, we need accurate and reliable information on which to base our decision-making when we set efficiency targets for Scottish Water. We also need accurate information in order to be able to assess Scottish Water's actual performance in meeting the targets. This is most likely to be achieved if Scottish Water works closely with this Office to understand our requirements. For our part we are keen to explain our analyses to Scottish Water.

6.5 Impact of the ten principles

In reaching agreement on the ten principles, we were adamant that any proposal should be consistent with the customer interest. We believed that this process should either improve our ability to undertake regulation, or improve the likelihood that Scottish Water would achieve its efficiency targets. The ten principles achieve these objectives by providing a framework for improving regulatory information and by establishing a common understanding of Scottish Water's targets.

A number of the principles came into force immediately once they were agreed between the parties. For example, the principles clarified the level of, and basis for, some financial and economic targets.

A number of the other principles required further action before they could be implemented. In particular, one principle concerned the introduction of a Reporter and another committed the Scottish Executive to consider setting up an appeal mechanism to the Competition Commission.

A Reporter for the water industry in Scotland was appointed in December 2003. Chapter 14 discusses the role of the Reporter and his contribution to effective regulation in more detail. This will include assessing the reliability of information provided by Scottish Water, and identifying areas where Scottish Water can improve the quality of its information. Knowledge of industry best practice allows the Reporter to indicate feasible improvements and how they might be achieved.

Principle 9 committed the Scottish Executive to consider an appeal route to the Competition Commission. The Draft Water Services (Scotland) Bill, which was introduced in June 2004, proposes a number of important changes to the regulatory framework, including granting us powers of determination and allowing Scottish Water a right of appeal to the Competition Commission.

The ten principles have helped clarify the roles of the economic regulator and of Scottish Water. We welcome their introduction as an important step forward in improving the regulatory process for the water industry in Scotland. This brings significant benefits to customers and stakeholders.

6.6 Conclusions

During the latter half of 2003 and first half of 2004, Scottish Water appears to have made good progress in relation to its efficiency targets. We consider that it is likely that this improvement has been encouraged by our agreement on regulatory targets.

The process of reaching agreement was not easy. It has, however, provided a sound framework for regulation of the water industry in Scotland.

Section 1: Chapter 7
The use of borrowing in the Scottish water industry

7.1 Introduction

This chapter examines the issue of the debt owed by the Scottish water industry, which is an increasingly topical subject. This covers both the debt owed to the industry by customers and the increased debt level of the industry.

There has been a great deal of discussion about whether or not the industry should borrow more and reduce prices to customers. This chapter reviews the arguments that have been raised in favour of a higher level of borrowing and concludes that a sustainable and prudent level of borrowing would be in customers' interests. Before concluding that borrowing a lot more now is in the interests of customers both now and in the future, it is important to consider not only the short-term price benefit that could result from increased borrowing, but also the additional exposure to risk, the potential disincentive to improve efficiency and the future level of prices.

The Scottish water industry is cash negative: that is to say it spends more than it receives in customer charges. This situation is likely to continue for the foreseeable future. As debt increases, so too does the total interest bill that must be met by customers. Managing debt at prudent and sustainable levels is therefore critical if the industry is to be able to respond to operational shocks.

The replacement cost of Scottish Water's assets has been estimated at £32 billion. Scottish Water has to invest consistently each year in maintaining its assets, and also has to cover significant operating costs. And it currently has an interest bill of £137 million. Table 7.1 summarises Scottish Water's expenditure in 2003-04.

Table 7.1: Outline of expenditure

	2003-04 £m
Capital expenditure	389
Operating expenditure	308
Public Private Partnerships	113
Spend to save	72
Interest	137
Total	**£1,019**

This chapter addresses the following issues:

- debt as a source of funding;
- debt in the Scottish water industry;
- transparency in the level of debt;
- the risk of a large debt burden;
- a proper use of borrowing; and
- the optimal level of debt.

7.2 Debt as a source of funding

Debt is a potential source of funds for a business; a company will borrow when it is short of cash. This may be for short-term operational reasons (for example to cover working capital until goods or services are paid for) or for investment. If a company borrows for operational reasons, the company has to budget for the interest costs and the repayment of principal. If a company uses debt as a source of funds for investment, management has to make sure that the additional return on the investment covers the interest payment and, ultimately, repays the capital.

In either case, the company is committing its future income to pay for today's cash resources. It is important to remember that debt is not an additional source of revenue.

Consideration of the prudency of increasing debt is more complicated in a regulated business. An economic regulator seeks to ensure that customer charges are set at the lowest level consistent with a sustainable business. The regulator will therefore typically only allow an increased return (ie increased revenue from customers) to be earned by a company if there has been a net increase in the total asset base. As such, borrowing any more than this net increase in the total asset base would not be prudent.

If a company continued to borrow in excess of the net new assets created, it would not take long for the revenue that its regulator allowed to be less than its outgoings (not including new investment). In a private sector context, insolvency would follow.

7.2.1 The funding of a public sector company

Public sector companies have two principal sources of funds: customers and loans provided by Government. When we set revenue caps in the *Strategic Review of Charges 2002-06*, we expected that Scottish Water would generate trading surpluses in each year. Our assumption was that these surpluses would be used to part fund the £1.8 billion investment programme. Unlike in the private sector, there are no shareholders who expect to receive a dividend (a share of the profit) and therefore all surpluses are re-invested.

Public corporations can also borrow from Government. Governments do not make lending decisions in the same way as bankers. A banker will primarily be concerned with whether the borrower will meet the interest payments and be able to repay the principal. The availability of government loans will depend principally upon public expenditure priorities and the state of the national economy. Government may therefore lend when a banker would not, and vice versa.

7.2.2 Additional funding options in the public sector

A possible alternative to borrowing from Government is to enter into a Private Finance Initiative or Public Private Partnership. These agreements can allow the public sector to reduce the extent of project risk that they face and to make use of the management and financial resources of a private company. In essence these contracts are very similar to a secured debt. The public sector organisation commits to buying a service on agreed terms for an extended period. These payments are made at least annually. The payments replace the annual interest payments and the operating costs that would have been incurred.

One of the advantages of such contracts is that they allow the public sector to access resources for investment, which may not otherwise be available because of restrictions on public expenditure. Quite significant set up costs are often involved with these contracts and, as such, major investment programmes will tend to be more suitable.

One important consideration is the cost of capital. The cost of capital is lower in the public sector than in the private sector. This cost disadvantage will require the private sector partner to accept risk, or be able to offer greater innovation or efficiency for the arrangement to represent value for money.

7.2.3 The funding of a private sector company

A private company has three potential sources of funds. It too can use previous surpluses and new debt to invest, but it also has the option of selling a part of itself in order to raise funds. Debt and equity funding are external sources of funds (the current owners actually pay now for these funds). Retained surplus (profit) is an internal source of funds, the use of which incurs only an opportunity cost in immediate income foregone.

A private company faces a number of different considerations when it comes to debt. The price (interest rate) that a company will pay for debt finance will depend on the banker's view of the likelihood of the company meeting interest payments and being able to repay the principal. The banker will set a higher price for debt when he perceives that there is a risk of default (not meeting interest payments or not being in a position to repay principal). The risk of default depends on the underlying trading of the company and other calls on its operating profit. A banker will require a higher interest rate when a company already has significant borrowing.

The second significant difference is that a company can face a refinancing risk. A refinancing risk occurs when a company reaches the end of a loan agreement and wishes to borrow to repay the principal on the previous debt. There are two main risks: first that a company is simply not able to borrow (circumstances have changed and the banks consider that the risk of default is too high); and second that the company may face a higher real interest rate (the actual interest rate less the rate of inflation). This would also be the result of a reassessment of the risks of default.

The second source of external funds for a private company is equity. This involves selling a part of the company. The current owners sell a share of the future profits of the company to a third party. This third party becomes a joint owner and has the same rights and responsibilities as other owners.

The retained surplus in the private sector differs from the public sector in that, in most cases, a share of the profit (dividend) will be paid out each year to the owners. If the company has the potential to grow its business significantly, owners may prefer to accept a lower share of the profits today in order to receive a higher share in the future. Likewise, they may choose to increase the use of debt (assuming that its cost is less than the expected return on the investment project) in order to maximise their share of the profit relative to the internal funds they have invested. Private investors will typically want to maximise the return on their investment.

7.2.4 Funding a regulated company

In the private sector the regulator will set a cost of capital that he considers sufficient to allow an effectively managed company to finance its functions. In establishing the cost of capital, the regulator will make an explicit assumption on an appropriate gearing ratio. The cost of capital is a weighted average of the cost of debt and the cost of equity (retained earnings and contributed capital). A company may try to improve the return for its equity holders by increasing its debt. Initially increasing debt may improve the return relative to risk, but as debt increases further it is likely that the return relative to the risk for the equity holder would get worse.

In a public sector model, the trade-off between debt and equity returns is not an issue. All retained earnings will remain in the business and will be used to the benefit of customers. In a regulatory capital model, customers pay a charge that depends upon the level of investment, the depreciation of the asset base, a rate of return on the regulatory capital value and allowable operating costs. The level of debt does not influence charges directly.

As new investment is added each year, the total value of the regulatory capital value will increase each year. Charges will gradually increase over time to reflect the larger capital value that needs to be remunerated. Customers do not therefore pay for the use of an asset before it has been added to the regulatory capital value. If the proportion of debt to regulatory capital value stays the same, there is no inter-generational wealth transfer. Moreover, if the cost of capital allowed on the regulatory capital value is the same as the borrowing cost of the public sector company, there should be no advantage from wanting to increase debt (beyond increases allowed as the regulatory capital value increases), and therefore risk future customers paying either too much or too little for the service that they receive.

7.3 Debt in the Scottish water industry

7.3.1 Scottish Water's current debt situation

Scottish Water was formed on 1 April 2002. It inherited debt of nearly £2.1 billion from the three former water authorities. In the *Strategic Review of Charges 2002-06*, we expected Scottish Water to increase its borrowing quite significantly in its first three years.

Table 7.2: Strategic Review of Charges debt profile

Financial year end	2002-03	2003-04	2004-05	2005-06
Net debt	£2,293m	£2,395m	£2,442m	£2,436m

Table 7.3: Actual debt profile

Financial year end	2003	2004	2005	2006
Net debt	£2,149m	£2,279m	-	-

As Tables 7.2 and 7.3 show, in Scottish Water's first two years, debt has increased less quickly than was anticipated in the *Strategic Review of Charges 2002-06*.

This is principally due to a slower start in delivering the capital programme.

In Table 7.4, we repeat an analysis of forecast debt that was provided to the Finance Committee during its investigation. We would expect to update this forecast based on information contained in Scottish Water's first draft business plan. However, it will almost certainly be considerably higher than the £2.4 billion targeted in the Strategic Review. The principal cause of higher debt will be delays in achieving the efficiency targets. Higher capital inflation may also be a factor.

A comparison of the current actual debt position with the assumptions in the Review is shown in Table 7.5.

Table 7.4: Debt forecast provided to Finance Committee

Closing debt – 31 March	2003-04 £m	2004-05 £m	2005-06 £m
	£2,279	£2,509	£2,709

Table 7.5: Variance analysis

Financial year end	2002 £m	2003 £m	2004 £m	2005 £m	2006 £m
Inherited debt	2,098				
Revenue		(7)	0	-	-
Operating costs		27	43	34	7
Investment		(84)	(11)	85	137
Spend to save		(14)	(35)	40	10
Interest payable		(12)	(12)	(3)	7
PPP Contracts		(6)	(3)	-	-
Other		(3)	45	28	45
Total debt		2,149	2,279	2,509	2,709
Cumulative debt Variance		(144)	(116)	67	273

7.3.2 Debt commutation

Many commentators have asserted that the Scottish water industry was treated unfairly in the amount of debt that was commuted when the industry was reorganised in 1996. They argue that the water authorities in England and Wales had all of their debt written off before they were privatised, whereas less than half of the total water and sewerage debt accumulated by the Regional and Island Councils was commuted. This assertion does not bear scrutiny; indeed, the Scottish water industry appears to have received a significantly better deal than the industry south of the border.

It is important to understand that debt cannot be commuted without cost implications for taxpayers and water customers. Only the original lender or a third party can remove the obligation to pay interest and repay principal at the end of the debt term. In the case of the original lender a loss of the original capital has to be accepted as well as a loss associated with the interest payments that are foregone. If a third party wants to eliminate the debt, they can repay in full or may choose to pay the interest charges and make gradual capital repayments or make a one-off payment at the end of the term.

The extent to which an individual customer may benefit from this policy would depend upon the extent to which they paid taxes and the relative benefit that they received from public services. Since domestic customers will typically benefit more directly from public services, such a commutation of debt is likely to benefit the commercial sector more than households. Therefore even if there were significant benefits in lower water charges, it is unlikely that this would be in the interests of all customers. Customers may mistakenly accept modestly higher increases in bills (effectively reduced only as a result of the debt commutation) because the full cost that they actually face (other public services foregone or increased taxes) is not immediately apparent. Moreover, there is a material risk that such an increase in the affordability of new debt for Scottish Water would reduce the pressure on management to improve efficiency.

At privatisation in England and Wales, net debt of £4.95 billion was commuted. In addition, the Treasury provided a cash injection (known as the 'green dowry') of £1.57 billion. The total cost of the transaction before the proceeds from privatisation was £6.52 billion. This is equivalent to £275 for every household in England and Wales. Privatisation raised £5.22 billion. The net cost to the Treasury of the reorganisation of the water industry, therefore, was £1.3 billion. The net cost per household was approximately £55. The Treasury also transferred accumulated tax losses of £7.76 billion to the companies, although this did not have a cash cost to the Treasury.

Financial reorganisation in Scotland was more straightforward. When the three water authorities were created in Scotland, the Treasury commuted some £700 million of a total of £1,700 million of local Regional and Island Council debt relating to water and sewerage activities. This left £1 billion of debt on the starting balance sheets of the three authorities. Clearly there were no receipts from privatisation to reduce the costs of the restructuring, so the total cost to the Treasury from this reorganisation was £700 million. This amounts to more than £330 per household. The cost to the Treasury was therefore around six times greater than that incurred from reorganising the water industry in England and Wales.

At the time of the Strategic Review, the industry in Scotland had £1.7 billion in tax losses. These were proportionately more than in England and Wales. These tax losses were transferred to Scottish Water by the Water Industry (Scotland) Act 2002.

It has also been argued that the Scottish water authorities were unfairly treated because of the high cost of embedded debt after 1996. This argument also does not stand detailed scrutiny. The average coupon (interest charge) on the embedded debt was 8.40%. However, this compares very favourably with the dividend yield of between 8.10% and 9.68% that had to be offered to potential shareholders in order to ensure that privatisation was a success[1]. In both cases, customers have to meet these costs.

The public sector industry in Scotland will also continue to have a cost of capital advantage. The interest rate charged by the Scottish Consolidated Fund is usually around 0.2-0.4% lower than the equivalent rate for the highest quality private sector debt.

The impression that customers in Scotland have been put at a disadvantage can only result from operational and capital inefficiency.

7.3.3 The cause of increasing debt

The total net debt of the three water authorities increased from £1 billion in 1996 to £2.1 billion in 2002. Debt increased because revenue was insufficient to cover the operating costs, capital investment and interest charges incurred by the three authorities. It could be argued that if the net debt added was less than the value of new investment, then the net asset value of the authorities was increasing. This would be misleading.

In economic terms, there are two important additional considerations: first, it would not be prudent to enter into debt (a real liability) to finance an asset that was worth less than the amount paid (eg an asset purchased inefficiently); secondly, a company must be able to earn a return on an asset if it is to meet the interest costs and repayment of principal associated with the purchase of the asset. In a regulated business this requires the regulator to allow sufficient return on the purchase price to meet the financing costs.

In the Strategic Review of Charges, our analysis identified that the efficiency of the Scottish industry lagged considerably behind that of the English and Welsh companies. In our Costs and Performance Reports[2] we began to look at the costs per customer of inefficiency. In our most recent report, we noted that out of an average domestic bill of £241, £80 or 33% was the direct result of inefficiency. Presented in revenue terms, this means that customers paid more than £300 million to finance inefficiency. The costs of this inefficiency were greater than the net new debt taken on by the three authorities. In real terms, the customer has received no value for the extra debt accumulated and it follows that the industry's finances have been made less sustainable by the increase in borrowing.

[1] The effective cost of interest payments is lower than immediately presented in this comparison because interest is an allowable expense for tax purposes, dividends are not. The post-tax comparison is 5.60% versus 8.10% to 9.68%.
[2] See our *Costs and Performance Reports 2001-02* and *2002-03*.

It is clear that the three authorities sought to delay price increases by increasing total net debt. Such an approach will increase customers' bills to a level higher than would otherwise have been necessary. The additional cost is at least the net present value of the annuitised interest payments (approximately equal to the amount borrowed). When a regulator sets prices using the regulatory capital value method, revenue is allowed only when an asset has been added; if interest obligations increase quicker than the allowed revenue, the company's financial position will worsen increasingly quickly. Ultimately, the company's solvency would be affected.

7.4 Transparency in the level of debt

From a customer perspective, it is important that the industry is managed on a sustainable basis. This requires the levels of revenue and debt to be kept in balance. In other words, management must face a hard budgetary constraint. This constraint is essential if customers are to have confidence that management will focus on improving efficiency.

A hard budgetary constraint will also impact on the owner of a business. The owner needs to take difficult decisions in the event that performance (for whatever reason) lags behind what is expected. The provision of some more short-term capital may be part of the solution, but there will also be a need to ensure that other steps are taken to ensure that performance reverts back to an acceptable standard. The ten principles (as discussed in Chapter 6) are a good example of such decisive action.

7.5 The risk of a large debt burden

7.5.1 The cost of debt can increase

Interest rates are currently at or around recent historical lows. The premium charged for longer term borrowing remains low. Consequently, additional borrowing and the refinancing of maturing debt has less of an impact on customers than it might have in the future. If interest rates increase and a premium for longer-term debt is re-established, then the impact of Scottish Water's greater borrowing will start to increase prices.

Some might argue that we should borrow more now because interest rates are low. This is, of course, an option so long as we are prepared to increase prices more quickly and probably to a higher level than would otherwise have been the case.

7.5.2 Exposure to operational shocks

The water industry is generally highly predictable. However, operational shocks can occur and can be a significant drain on resources. A good example is the cost of the drought in 1995 for Yorkshire Water (approximately £250 million), which had to be absorbed by equity holders of the company. In a public sector context there are no equity holders to absorb this risk. The result is either a direct increase in prices immediately or an increase in debt with a smaller, though permanent, increase in price to customers. In effect, addressing such a shock through increased debt will penalise future customers – unless the industry has been managing its debt level to take account of the possibility of an operational shock. This is discussed in more detail in our paper to the Finance Committee[3].

In addition, the private sector provides a further level of risk management that can benefit customers. The higher cost of capital required by the private sector increases bills to customers. However, customers benefit because within the private sector model there are strong incentives that help to reduce the exposure of customers to financial risk. The commercial interests of the company are served by ensuring that management takes action to minimise the impact of external shocks on the business.

7.6 A proper use of borrowing

7.6.1 To smooth peaks in investment

Borrowing can and should play an important role in smoothing the cash needs of Scottish Water over periods of particularly high investment. However, the

[3] *Ensuring a financially sustainable water industry in the public sector*, 13 February 2004.

borrowing should only be used when legislative, practical, or operational deadlines require accelerated capital spending. There appears to be no realistic likelihood of efficient capital spending declining in real terms in the foreseeable future. It is argued that we should borrow to pay as we receive the benefit of the use of the assets. The burden of payment is therefore spread across those who benefit. This works for projects that are one-off: for example, the building of local swimming pool. The water industry is quite different in that it owns a huge portfolio of assets.

It is generally agreed that a generation should pay the full cost of the water and sewerage services that it consumes. By its very nature, investment expenditure will be subject to peaks and troughs. Proper long-term planning and management of the asset base and the use of borrowing can be effective in smoothing these peaks and troughs. The very long useful life of assets in the water and sewerage industry lends itself to effective forward planning. Even the introduction of tighter environmental and public health targets tends to involve relatively long lead times, which can be used to adapt investment plans to ensure their effective and timely introduction.

A useful example is that of a typical water main. The expected life of a water main is around 70-80 years. This average is broadly similar to average life expectancy. If, therefore, an individual lived in the same house for the whole of their life, it would be reasonable to expect that the water main supplying that property would be replaced once during the life of that individual. Obviously, the replacement of this water main could happen at any time during the life of the individual. Customers contribute to charges during each adult year of their life; some may pay in advance of receiving a new water main, others receive the new main earlier and pay for the remainder of their life. In effect, the whole customer base jointly purchases each year a quantity of refurbished mains which will keep the system in a fully serviceable order – they do this while recognising that they will benefit only once during their life from the replacement of the main but will during all the other years have access to a safe, potable water service.

Another way of looking at this is to say that those, in any one year, who receive the new water main are borrowing from their fellow customers the excess of their contributions through charges prior to replacement of the main. In other words, the customer who receives a new main to serve their property before they begin to pay for the water service borrows the entire amount from fellow customers. The customer who receives a new main half way through their adult life will borrow approximately half the cost of the main from other customers, the rest being funded by contributions already made. Customers promise to continue to pay charges even after replacement of the main, in settlement of their debt (to fellow customers), and these contributions allow each year for others to benefit from the refurbishment of the main that services their property. If the average rate of deterioration of the water main were regarded as broadly similar, each householder would receive the same average service over any period of 70-80 years.

The same principle applies to shorter life assets, such as technology (which would have a very short asset life of say 3-4 years) or water treatment plants (which have an asset life of 25-30 years). They would be replaced on average between 3 (water treatment) and 25 (technology) times during the average customer’s life. The result is that the portfolio of assets owned by a water authority can be properly maintained by an annual sum of money, which, if consistently invested, will ensure that the serviceability of the network is maintained.

On occasion there will be a need to improve the water and waste water assets that provide service to customers, to meet a new higher standard, rather than replacing on a ‘like for like’ basis. Deadlines in these circumstances are likely to force the water authority, on behalf of all customers, to borrow in order to meet these obligations. This allows the costs to be spread over time. Such improvements will, however, inevitably increase the amount of money that the water authority has to raise from customers in order to bring the money raised and the asset replacement liabilities back into balance.

7.7 Conclusions: the optimal level of debt

7.7.1 A level of debt consistent with sustainably affordable prices

It is important to take full account of the consequences of decisions about borrowing. If borrowing increases prices for future generations simply to delay price increases which the current generation should bear (for example, not paying for inefficiency) then this penalises future generations. If the costs of borrowing are less than the extra return that a regulator will allow for the addition of an efficient new asset, then there is no problem with an increase in borrowing.

Importantly, borrowing should not be seen as a short-term solution to underperformance unless other measures are also taken. Borrowing to fund underperformance does not create any additional value for customers. No new customers are added to the network, no improvements are made to the environment and public health performance of the assets and no improved maintenance regime is introduced. The borrowing could be justified, however, if steps are taken to ensure that performance improves. Management's interests must be aligned with those of the customers: an affordable sustainable industry.

7.7.2 Debt must be prudent

It is important that a company retains financial flexibility so that it can respond effectively to any operational or legislative shocks. There are fewer financing options in the public sector, so any shocks will typically impact on customers more immediately than in the private sector. It would therefore benefit customers if the management takes borrowing decisions such that all of the costs of a shock do not fall on future generations of customers.

7.7.3 Treasury rules

In the public sector, it is important that borrowing is consistent with the Treasury's 'Golden Rule'. Although the Golden Rule applies to the management of the Government budget, its broad principle could also be applied to a public sector water business. The Golden Rule is that:

> "over the economic cycle, the Government will borrow only to invest and not to fund current spending".

The Treasury's Golden Rule was introduced to ensure that, as a country, we measure the level of our current consumption accurately. The rule warns against turning to borrowing to meet the costs of current consumption. It states that to borrow in order to fund current consumption would be unfair on future generations who would be left with the bill.

In a long-term industry, such as water, it is desirable to apply the same principles. This would require us to take a prudent view of current consumption. Of course, it is not straightforward to assess the full economic costs of providing a water and sewerage service to the current generation. However, few would argue that these costs ought to include the true underlying deterioration in the asset base of the water industry in Scotland.

Some commentators have interpreted the Golden Rule as implying that borrowing should, as a matter of course, be used for all investment that adds any value to the asset base. This, however, would not be a correct interpretation. The Golden Rule does not require that borrowing must be used in every case of investment that adds any value to the asset base. The Golden Rule requires that account is taken of the likely capital spending over the investment cycle – which for the water industry can vary from the medium to the very long term. In particular, the Golden Rule requires a proper distinction to be made between what is really current consumption and what is genuine long-term improvement of assets. In other words, before borrowing, we should be sure that we are genuinely investing sufficiently to improve the average quality of the asset base.

In this regard, it is important to note that most observers expect that investment will continue to have to increase. Moreover, the Golden Rule does not in any way sanction borrowing irrespective of the ability to pay back both the principal and interest on a loan within the investment cycle.

As outlined above, much of the investment in ‘new’ assets reflects ongoing trends, in that society’s expectations about water purity and environmental cleanliness continue to rise, and ‘new’ assets will always be needed to match changes in customer numbers and location. It could reasonably be argued that the Golden Rule would require such ongoing recurrent costs to be met without long-term borrowing. Given that we know there will be an ongoing need for investment in improving the environment and public health for at least the next 10-15 years, it would be inconsistent with the Golden Rule to borrow to meet the costs of any part of the new investment that has an expected asset life of less than 10-15 years.

I did not adopt such a strict interpretation of the Golden Rule in the Strategic Review of Charges. I did, however, apply a financial constraint, as explained below, to ensure that Scottish Water could cover its costs.

7.7.4 Prudent borrowing in England and Wales

When setting a cost of capital, Ofwat consults extensively with the credit rating agencies and the providers of finance. Ofwat will take account of these expectations in setting prices. Ofwat sets the key financial ratios that it regards as consistent with the sustainable financing of the industry[4].

Ratio	Threshold
Historic cost interest cover	minimum 2.0x
Average debt/capital 2000-2005	45%-55%
Cash interest cover (EBITDA)	minimum 3.0x
Cash interest cover (EBIDA)	minimum 2.0x
Debt payback period (EBITDA)	maximum 5 years
Debt payback period (EBDA)	maximum 7 years
Cashflow to capex ratio (EBDA)	minimum 40%

These indicators are not an attempt to force companies to adopt a particular capital structure. Ofwat views these indicators as consistent with its cost of capital – if a company manages its finances differently this may impact adversely on its cost of capital and hence the sustainability of its financing.

4 *The tide turns for the UK water sector: Assessing the impact of the regulatory review*. Moody report, page 7, 17 August 1999.

Section 1: Chapter 8
Finance Committee Inquiry

8.1 Introduction

This chapter describes the background to the Finance Committee's investigation into the Scottish water industry; the evidence that was presented; the Committee's conclusions and the response of this Office to those conclusions. We also summarise the Scottish Executive's response. This response, and their detailed proposals included in the Water Services etc (Scotland) Bill, are also covered in more detail in Section II.

8.2 Background

In June 2003, the Finance Committee of the Scottish Parliament agreed to write to various organisations to establish the current position of the water industry in Scotland with a view to pursuing an investigation into Scottish Water at a later date. The Committee wrote to a number of organisations including:

- Scottish Water
- The Water Industry Commissioner for Scotland
- Scottish Council for Development and Industry
- CBI
- Federation of Small Businesses
- Forum of Private Businesses
- Scottish Trades Union Congress
- Convention of Scottish Local Authorities
- Water Customer Consultation Panels
- Drinking Water Quality Regulator
- Communities Scotland.

In November 2003, the Committee appointed two of its members, Jim Mather, MSP and Jeremy Purvis, MSP to act as reporters on behalf of the Committee. The Committee agreed the following remit for the reporters' investigation.

> "To investigate the following issues:
>
> - accountability – looking at the role of the Water Industry Commissioner, the relationship with Scottish Water, the Scottish Executive and local authorities;
> - structure – looking at water charging and debt management;
> - investment – looking at capital projects, the profile of procurement and borrowing, billing and financial management; and to suggest potential areas for the questioning of Scottish Water and the Water Industry Commissioner…."

The Committee published its report in April 2004. The Scottish Executive made an initial response almost immediately and a further response on 14 June 2004. We responded to the Committee at the beginning of June 2004.

8.3 Reasons for the investigation

An increasing amount of press attention had been given to water industry issues during 2003. These included:

- delivery of investment and an apparently increasing number of development constraints;
- disagreements between this Office and Scottish Water about its performance;
- the large increases in charges that some small businesses had faced – this had become a high profile issue, with representative organisations such as the Federation of Small Businesses and the Scottish Forum for Private Business raising concerns; and
- a paper written by Analytical Consulting Ltd, and submitted to the Finance Committee, suggesting that public expenditure rules had been incorrectly

applied and that customer charges were higher than necessary as a result.

8.3.1 Delivery of investment and development constraints

In its consultation on the level of investment during the *Quality and Standards II* period, the Scottish Executive set out three distinct investment strategies. Only the 'enhanced' option contained any significant money for development constraints, although it was recognised that some of the infrastructure renewals and quality investment programme would help ease development constraints in some areas. After the consultation, the Scottish Executive decided to adopt the middle option, but to add a further £50 million to address demand for first time water and sewerage connections in rural areas.

In the Strategic Review of Charges 2002-06, we advised Ministers that Scottish Water should be able to deliver the required investment outputs for £1.8 billion. This was a reduction of some £500 million on the total cost of the programme that had been estimated by the three former water authorities. The progress in delivering the investment programme in the first year was slow. This slow progress undoubtedly increased the frustrations of local developers and planners.

Concerns about development constraints did not relate to a single area of Scotland, but came from both rural and urban areas and from across the country. These concerns were exacerbated by a misunderstanding of the capital expenditure efficiency targets that underpinned our advice to Ministers in the *Strategic Review of Charges 2002-06*. We believe that an efficiency in no way compromises output or risk profile. As such we continue to believe that the combination of customers' charges and new debt from the Scottish Executive should ensure that Scottish Water has sufficient resources to meet all of the outputs of *Quality and Standards II*.

8.3.2 Disagreements about performance

In the *Strategic Review of Charges 2002-06*, we recommended that Ministers "..require the publication by ..[this] office of annual reports on the performance of the water industry in Scotland. These reports would cover operational costs, delivery of investment and the level of customer service". We were concerned that performance should be measured objectively and that customers should have access to reliable information about the quality and cost of the service they receive.

When we completed our analysis in 2001, it was clear that the industry in Scotland would have to make considerable progress in order to meet the service level or the cost performance of the companies south of the border. There was clear evidence from England and Wales that objective annual statements of performance had stimulated companies to seek to improve their relative position. We understand that no management will ever want to be shown to be at the bottom of the league in performance terms. However, recognising the required level of improvement is a vital first step in making the progress that customers have the right to expect.

We want Scottish Water to be successful since this will ensure that customers receive value for money. These reports will continue to play an important role in encouraging Scottish Water to improve.

8.3.3 Increases in charges to small businesses

Many small businesses faced large percentage increases in their bills between 2002-03 and 2003-04. Small customers in the former West of Scotland Water Authority area were worst affected. Three factors came together to cause these increases. It is unfortunate that comment on these increases focused mainly on the increase in standing charges.

The Strategic Review of Charges had recommended an increase of 7.8% in the revenue cap of Scottish Water. The three authorities would have required a larger increase in their revenue (at least 10.3%) had the creation of Scottish Water not been approved by the Parliament. Most smaller businesses would have seen an increase modestly in excess of the revenue cap if there had been no harmonisation and no move towards cost-reflective pricing.

In the Review we highlighted the potential risk to Scottish Water's revenues (and hence the charges of all bar the largest water users) from competition. This risk could be mitigated if Scottish Water improved its efficiency and cost allocation. It was also likely to be important that Scottish Water's tariffs should reflect the cost of providing the service.

Cost-reflective tariffs were likely to mean relatively higher standing charges and relatively lower volumetric charges. The main costs of supplying a water and waste water service are fixed; that is, they only vary slightly with the amount of water used or waste discharged. It is therefore reasonable that a cost-reflective charging structure should have a relatively high standing charge.

It was clear that prices in the former North of Scotland Water Authority area were going to rise faster and further than charges in the southern half of Scotland. One of the perceived benefits of the creation of Scottish Water was that charges could be harmonised across the country. The costs of harmonisation would be felt most in the former West of Scotland Water Authority area. It would also have an adverse impact on small business customers in the former East of Scotland Water Authority area that had a high rateable value, but benefit identical customers in the former North of Scotland Water Authority area.

The very high percentage increases resulted for customers who had very low bills (it would often have been more economic to provide the service free of charge to avoid billing costs). These customers faced an upward move in their bill as a result of the underlying increase, the harmonisation and the move towards a more broadly cost-reflective charging system.

8.3.4 Error in implementing public expenditure control targets under resource accounting

The Finance Committee considered a paper from Analytical Consulting Ltd[1] in January 2004. The paper suggested that customers' bills were higher than necessary because of an error in implementing the public expenditure control targets under resource accounting.

Analytical Consulting Ltd believed that there was an error either in the way the Scottish Executive had set borrowing limits in their commissioning letter and/or in the way that we had interpreted these limits. Their paper, our response and the response of the Finance Committee are covered more fully in Chapter 4 of this document.

8.4 Evidence

In oral evidence to the Committee we were asked about our use of financial ratios. Financial ratios are difficult to use consistently when the financing arrangements and capital and ownership structures of the organisations to be compared are quite different. Our evidence used ratios that we believed to be broadly consistent as measures of the relative sustainability of both models.

During their evidence to the Committee, Analytical Consulting Ltd took issue with these financial ratios and suggested that this had resulted in customers being overcharged. We submitted a detailed paper *Ensuring the sustainable financing and operation of a public sector water industry*, which we considered addressed these criticisms[2].

8.5 The Committee's findings and our responses

A copy of the Committee's report is available on the Scottish Parliament's website (http://www.scottish.parliament.uk/finance/index.htm). The Committee made 21 recommendations as a result of its inquiry.

We welcomed the Finance Committee's report, and its scrutiny of the water industry in Scotland. In our view the report should help ensure that all customers will benefit from a more sustainable water industry. We would like to

1 Analytical Consulting Ltd, *Did flaws in the application of resource accounting and budgeting distort the Strategic Review of Water Charges in Scotland*, unpublished, available at http://www.scottish.parliament.uk/finance/reports/fir04-02-vol02-03.htm#7
2 This paper is available on our website at http://www.watercommissioner.co.uk

register our agreement with many of the points made in the report.

In particular, we welcome the recommendation from the Finance Committee that the regulatory framework in Scotland should be strengthened and better resourced. It is noteworthy that the Committee also commented upon the importance of significantly improving the efficiency of the water industry in Scotland. Matching the efficiency of the water industry south of the border will take time, but customers will only benefit from the industry remaining within the public sector once the current gap is narrowed very considerably.

The comments of the Committee regarding the improvement in the quality of financial, customer and asset information are also welcome. We believe that this Office has made considerable progress in developing the information systems that underpin effective regulation. This information is supplied to us by Scottish Water in an annual regulatory return and is available in full on our website. The quality of this information has improved significantly over the past three years and we would expect that such improvement will continue over the next few years. Our Office has recently appointed a leading firm of consulting engineers to review the information provided by Scottish Water. This appointment of a Reporter follows the example of Ofwat in England and Wales.

We agree that the strengthened regulatory regime should be more clearly accountable to customers. The current role of the Water Industry Commissioner for Scotland, as defined by statute, is to advise Scottish Ministers and to approve schemes of charges proposed by Scottish Water so long as they are consistent with the advice provided to, and accepted by, Scottish Ministers. This advice is provided within a defined policy framework (for example, that there should be a link between domestic water and sewerage charges and Council Tax bands).

In evidence, we suggested that economic regulation should work in broadly the same way as for other utilities. This model requires that Ministers provide clear guidance on social, environmental and public health priorities and that the regulator should then manage a transparent process, which leads to decisions on the maximum prices that can be levied on customers. Scottish Water should have the right of appeal to the Competition Commission. This very clear process is likely to reduce the current uncertainty amongst stakeholders on roles and responsibilities. As a minimum, it would be easier to explain the roles and responsibilities of each stakeholder.

We also responded in detail to individual points raised by the Committee. The Committee's conclusions and our responses are detailed below.

28. It is clear that the optimistic forecasts of minimal price impacts from harmonisation of prices across Scotland were not realised. Efficiency gains from the greater economies of scale should have minimised any price impact. Instead between 2001-02 (the last year of the three separate authorities) to 2004-05 (the current year and harmonisation of prices at £338.31) customers in the East are paying 25.3% more (£68.31), customers in the West are paying 27% more (£71.91) while the North is paying marginally less –3.4% (-£11.87). This is at variance with the estimate provided by the WIC. The Committee is not convinced of the WIC's estimate and explanation of the impact of harmonisation on customers in the East and West

We have reviewed again our calculation of the impact of harmonisation on the average household in the East and West. We can confirm that the estimate that we supplied to the Committee, on the impact of harmonisation on the value of the average domestic bill, is accurate. There would appear to be two principal reasons for the misunderstanding. Firstly, the Report includes a table that details changes in the Band D bill – this is significantly higher than the average domestic bill, which is between the Band B and the Band C levels. Secondly, the substantially increased level of investment included in *Quality and Standards II* resulted in an overall increase in prices that could only be partially offset by the efficiency targets that were set for capital and operating costs. It would not be reasonable to include the increase in prices resulting from the higher level of investment in an assessment of the impact of harmonisation for domestic customers. Moreover, both domestic and non-domestic customers in all three water authority areas would have faced even greater increases in their bills if Scottish Water had not been created.

In our response to your question about the costs of harmonisation for the average household in the East and West, we referred to a lack of detailed information to calculate the exact impact of harmonisation. The Committee should note that this related only to the detail of the exact number of Band D equivalents for the areas previously served by the three authorities (ie the spread of properties by band and the incidence of discounts). Such differences are not hugely material and as such it is likely that this information would have had only the most minimal impact on our assessment of the cost of harmonisation for the average domestic customer.

In the three authority model the prices paid by non-domestic customers with similar usage patterns or rateable values could be quite different. Consequently the impact on the prices paid by some customers resulting from harmonisation could potentially be greater for non-domestic customers than it was for domestic customers. We highlighted some of these differences in the Strategic Review of Charges when we provided examples of typical customers.

Differentiating between household and business customers is not straightforward: households with meters have historically been regarded as non-domestic properties and there can also be issues with businesses run from home, care homes, owners living in a flat above a hotel or farmhouses and crofts. There is still a material incentive to many lower water users living in higher banded domestic properties to switch to a meter. Such switching will result in higher prices for other customers.

35. The Committee is concerned that there does not appear to be agreement between the WIC and Scottish Water on how much progress is being made with regard to efficiency savings and operating costs and is also concerned over what the impact could be if the necessary savings are not met.

The Committee is correct to be worried about the impact on future prices of a failure to meet the efficiency targets that were set in the Strategic Review of Charges. We believe that it is important to reiterate our definition of efficiency – it is the delivery of a defined level of service for less money. Consequently, adjustments to costs incurred are made to ensure that we are making like-for-like comparisons and therefore an objective assessment of efficiency. It is not in the customer interest to allow changes in accounting practices to be considered an efficiency – they would not, of course, reduce the revenue required from customers.

In the Strategic Review, we set three efficiency targets: in base operating costs (set separately for each of the three authorities); a further reduction in operating costs because of the benefits that should accrue from the creation of Scottish Water; and in capital expenditure. These three efficiency targets, taken together, amounted to some £400 million per year in 2005-06 and limited the increase in revenue required from customers to just under 20% from over 70% over the four years.

It is not uncommon for there to be disagreement between the regulator and the regulated organisation about both the level of the efficiency target and progress towards that efficiency target. Our role is to monitor progress of Scottish Water on a fair and objective basis. As such, our comparisons reflect the actual underlying progress in improving value for money for customers. Customers can therefore be assured that comments from this office will be supported by appropriate evidence and underpinned by a consistent methodology.

59. While the Committee understands the Scottish Executive's reasons for promoting the equalisation of domestic bills across Scotland, the consequences in terms of increased charges were not adequately explained to consumers and appear to have been underestimated. Astonishingly, the impact of the harmonisation of business charges on low volume business

users appears not to have been foreseen. No economic justification for business charge harmonisation was given either by Ministers or the WIC, despite its significant impact on firms adversely affected. The failure to openly debate and consult on harmonisation and the specific harmonisation methodology that was implemented for business users, as well as the failure to introduce such a significant change on a phased basis, has caused a great deal of distress to small businesses.

The desirability of harmonised charges was recognised in the discussion that followed Sam Galbraith's announcement to the Transport and Environment Committee in February 2001 of the Scottish Executive's intention to create Scottish Water.

We accept that many of those who faced sharp increases in bills believe that there was insufficient debate and consultation about the change in tariffs. Any such change in tariffs is likely to be unpopular with those who end up paying more and accepted as right and proper by those who benefit. In this regard, while we can sympathise with businesses who were asked to pay more, we also believe it is important that we remember that there were many businesses that benefited from the change in tariffs and that they had been paying relatively higher (than others of a similar type and pattern of usage but located in another authority area) bills since 1996. After the creation of Scottish Water it would have been very difficult to justify continuing to charge a significant water user in the North nearly 100% more per cubic metre of water and nearly 500% more for surface drainage.

In the Strategic Review of Charges, we indicated that the non-domestic sector in Scotland paid a greater share of total industry revenues than in England and Wales (42% of revenue in Scotland versus 20-30% in England and Wales) and found little reason to believe that such a marked difference should exist. At that time, a lack of detailed cost information meant that Scottish Water's costs in providing service to non-domestic customers could not be assessed reliably. As any reduction in non-domestic revenue would have to be offset by an increase in domestic bills, we concluded that an adjustment could only reasonably be made when Scottish Water was able to present clear evidence to justify increasing domestic charges relative to non-domestic tariffs. This is in line with standard regulatory practice where the onus is on the company to show that a rebalancing of costs between customer groups is justified.

During our programme of consultation, we received many representations from businesses and business representatives that differential charging based on location was unfair.

For example, Fife is a relatively high cost area but benefited from lower charges because it was in the former East of Scotland Water Authority, but customers based in Dundee, which has a relatively low cost of supply, faced much higher prices since they were supplied by the North of Scotland Water Authority.

Discrepancies of this type were particularly apparent to customers paying water charges for similar properties located in each of the three areas. Maintaining different tariff regimes for different parts of Scotland would have been both expensive to administer and likely to have encouraged 'cherry-picking' of larger customers in the high tariff areas. It is important that competition brings benefits to all customers by encouraging efficiency and innovation. We were aware of a number of anomalies in the tariff regimes of the former authorities that increased the risk of 'cherry-picking': for example, a supermarket chain, with large stores located in Dundee, Glasgow and Edinburgh would have faced substantially different bills in different parts of Scotland. There is no cost justification for such variations.

The table below shows the bills that applied in 2002-03 for each of these stores:

Table 8.1: Example of typical Bills 2002-03

40mm meter, water volume 13,000m^3, RV = £1,145,000[3]	Dundee	Glasgow	Edinburgh
Total bill	£83,068	£55,515	£37,418
% of Dundee bill	100%	67%	45%

[3] Customer characteristics are typical of those for a large supermarket based in a Scottish city.

In evidence, the Finance Committee heard that ".. it is an unusual notion that would take a strategic asset like water and say that, no matter whether someone lives in Rannoch or the top of the Cairngorms, the same pricing policy will exist for all" (paragraph 57). However, other utility businesses operating in Scotland do precisely that. Scottish Gas and BT apply the same charges across the whole of Scotland, whilst the Scottish electricity companies (Scottish Power and Scottish Hydro-Electric) each apply the same tariffs throughout their respective areas. It would seem not unreasonable, therefore, for Scottish Water to apply uniform tariffs, regardless of location. Certainly considerable thought should be given to the implications of the location signals that would be given to developers of encouraging a major water user to locate, say, in North Fife (a high cost water area) rather than in, say, Dundee (a low water cost area).

There is an alternative approach, which would be to set prices that reflected the local costs of supply. Such an approach would be likely to disadvantage more remote areas or areas where there are problems with the supply/demand balance of water. The islands, the southwest of Scotland and the north Fife area would have been most disadvantaged.

The main reason for the large increases for most smaller businesses was not so much harmonisation, but the move towards more cost-reflective tariffs. In the Review of Charges we highlighted the benefits that accrue from developing charges that broadly reflect costs. These benefits can be split into two main categories: reduction of vulnerability to competition and improved revenue collection.

Off-network competition is more likely to occur where a customer pays a bill that is greater than the costs of supplying them. If a large customer moves off the public network then the total revenue from that customer is removed, however, the fixed costs of supplying the customer remain. These costs must be borne by the remaining customers of the supplier. Clearly, moving towards cost-reflective tariffs reduces the likelihood of groups of customers moving off the public network by ensuring that customer groups pay a price related to the cost.

In the water industry the main costs of supply are fixed – they relate to the cost of developing and maintaining a network to cope with peak demand. There is a relatively low amount of cost that varies directly with the average water volume consumed over a longer period (such as a year). A cost-reflective charging structure is likely therefore to contain a large element of fixed charge.

For customers who paid a price determined by their rateable value this meant that a minimum charge was introduced. This impacted a large number of customers in the former West of Scotland Water Authority and North of Scotland Water Authority although it tended to benefit such customers in the former East of Scotland Water Authority.

The effects of moving to broad cost-reflectivity, for some customers, were increased by the removal of abatements and the phasing out of charitable relief.

We agree that there should have been better communication of this change in the tariff structure. It is, however, important to make two points.

The overall increase in revenue from non-domestic and domestic customers across Scotland was broadly the same. Just over 20% of businesses saw a fall in their bill, about 10% were not impacted and about 70% faced higher bills.

Some businesses faced bills that were unrealistically low. For example, businesses with identical usage characteristics to a household could be paying quite significantly less than that household. There were also many examples of hotels, guesthouses and even a manufacturer of ice who paid bills which were less than a Band A household.

80. The Committee recommends that to give the public greater confidence in the quality of the consultation carried out, both Scottish Water

and the WIC should operate under clear consultation codes with consistent approaches to publication of responses. In particular, all consultation submissions made to the WIC should be made public before any of his statutory reports are released and the WIC should address the relevant issues raised by consultees within the reports themselves. In this way, the public can be reassured about the conduct of the relationship between the WIC, Scottish Water, its customers and the Scottish Ministers.

We agree that the introduction of such a code would be of benefit. Our Office will prepare in draft and consult on such a code. It would be useful to formalise this in Statute in the forthcoming bill.

83. The Committee believes that it would aid the accountability and transparency of the WIC in the view of many customers if he had to give a formal response to submissions from the Panels, which could also be lodged with the Parliament.

We would agree that this proposal could bring benefits. There would however be a resource implication associated with preparing an appropriate detailed written response to all submissions.

84. The WIC is both financial adviser and guardian of the public interest but was unable to provide the Committee with a clear illustration of how the public interest is determined where different interests have to be balanced. For example, weighing lower prices to the customer against the long-term sustainability of the water supply network is an important decision that has been taken with little public debate.

In our evidence to the Committee, we explained that our role is technical, not political nor representational of particular groups (as opposed to customers as a whole). This technical role should ensure that the aims of Ministers are delivered, for the lowest justifiable cost to all customers.

The Strategic Review drew on guidance from Ministers on the level of performance expected from the water and sewerage network. *Quality and Standards II* provided the vehicle for this guidance. *Quality and Standards II* was itself the subject of a wide public consultation and the final outcome was refined to reflect the views expressed by consultees. We were not required, nor did we seek, to weigh lower prices against long-term sustainability of the water supply network. Indeed, unlike Ofwat, we did not seek to question the views or priorities of the quality regulators (SEPA and the Drinking Water Quality Regulator) and ensured that Scottish Water was fully funded to meet all the priorities set by Ministers in their response to *Quality and Standards II*.

In this regard, it is again important to stress that our efficiency targets are met when all the investment outcomes are met, on a sustainable basis, for the reduced cash budget made available. Delaying a project to the next regulatory period or changing the scope of a project and reducing its benefits are **not** efficiencies. The efficiency targets were set after a detailed consideration of what had been achieved in England and Wales and a full review of current practices in Scotland. The setting of efficiency targets therefore should not have resulted in any reduction in the investment outcomes set by Ministers. One such outcome was that there should be no deterioration in the performance of the underground infrastructure. This clearly implies that Scottish Water would be expected to manage any operational risks within their revenue settlement.

The Committee should also note that even if Scottish Water achieves the efficiency targets set for the current regulatory period, around 20% of the average bill (for both domestic and non-domestic customers) results directly from inefficiency in the delivery of capital investment and in operating costs.

85. The Committee is concerned that there is a lack of transparency in the way in which the roles of the WIC as regulator and customer champion are combined and that there is a perception in the minds of at least some stakeholders that there may be a conflict of interest between the WIC's

stated role as a champion of current consumers and being a vital element in the drive for the water industry's long-term efficiency.

The statutory duty of the Water Industry Commissioner for Scotland is to promote the interests of customers. Our principal weapon in promoting customer interests is to challenge the industry to improve its efficiency and to improve its level of service. We do this by trying to ensure that we advise Ministers on the steps necessary to ensure that all current and future customers will benefit from a sustainable water and sewerage industry.

Specifically, the remit of the Office does not extend to supporting the interests of one group of customers when this would disadvantage others. To this extent, some may consider that we are not the 'champion of customers' – but it is not the role of a regulator to favour one or another group. Such decisions regarding the price of a public service provided by a public sector organisation are political and should, rightly, be taken by Ministers and the Parliament.

Our role is to operate in line with guidance issued to me by Ministers and the advice accepted by Ministers. We therefore seek to ensure a broadly cost-reflective allocation of costs between customer groups and then, through promoting efficiency, to reduce costs to all customers. In this way, we could reasonably be considered as the 'champion of all customers'.

Throughout the regulated industries, the recognition of the potential conflict of interest between regulator and 'customer champion' to which the Committee seems to refer has led to the creation of separate customer bodies such as Energywatch, Postwatch, Rail Passengers' Council, WaterVoice and, in Scotland, the Water Customer Consultation Panels (WCCPs). We welcomed the creation of the WCCPs as it brings clarity to the role of promoting customer views and the representation of particular customer groups.

87. The current WIC told the Committee that a subsequent WIC may take a wholly different approach to providing advice on a charging structure. This is not conducive to long term planning for the industry, continuity of the office and neither does it display much thought to the representative nature of the WIC in making advice.

Please see my answer under 84 above. The nature of my role is to promote the interests of all customers now and in the future. WICS does not have a representative role; the WCCPs has a duty to represent the views of customers.

My principal weapon in promoting customer interests is to challenge the industry to improve its efficiency and to improve its level of service.

88. The Committee believes that an improved structure and support for the WIC is needed to ensure independent regulation and transparency across the industry. Modelled on some of the English and UK regulators, an Office of the Water Industry Commissioner, including a non executive membership, could provide greater accountability and continuity for the Scottish water industry. Consideration should be given to whether certain decisions should be taken by the WIC in the context of advice from Ministers rather than the reverse.

We agree. We have been advocating for some time that, in the interests of customers, the water industry in Scotland should be regulated in a way that is more transparent and accountable, consistent with UK regulatory policy.

We welcome the proposals announced by the Minister in response to the Finance Committee report with regard to the creation of a regulatory board structure with non-executive membership. This will strengthen the regulatory function and increase transparency to the benefit of all customers.

A regulatory board would be an invaluable source of advice and support to the executive staff of WICS. It may also help to depersonalise the interactions between WICS and Scottish Water. We had sought to gain some of the long-term benefits of a regulatory board by establishing an advisory panel. This panel includes experts from the legal, regulation, business, academic and public service worlds. Unfortunately, owing to budgetary constraints, we have had to disband this Panel for the time being.

In particular we would advocate a move to a regulatory regime, more consistent with UK regulatory policy, in which the regulatory board sets price caps and determines charges based on guidance from Ministers. This will improve clarity of roles within the industry and help ensure that customers can benefit from the potential advantages of the public sector model.

129. When the WIC was before the committee, he implied that his financial limits were not particularly stringent in the light of what the English regulator did and in the light of the sorts of ratios that were achieved by water companies in the commercial sector in England and Wales. However, there was concern expressed by members of the Committee that the basis of comparison appeared to be different and therefore the committee sought clarification from the WIC about the basis of comparison between financial ratio targets set in Scotland compared with those in England and Wales and found that there were very considerable differences between the bases on which these targets were calculated, invalidating the comparisons which had been suggested. In a letter to the Committee dated 27 February 2004, ACL highlighted that the basis used for Scotland is "revenue – less operating expenditure". Whilst broad financial ratio analyses can add clarity in making comparisons, they can be misleading where non-comparable bases are used to assess performance. The Committee found unacceptable the WIC's use of comparisons between Scotland and England and Wales without making clear the impact of different bases of calculation. Where different bases are used this should be fully explained to ensure transparency.

Having reviewed our oral evidence, we would agree that we should have been clearer about the basis of calculation of the respective ratios in Scotland and south of the border. The comparison was designed to indicate the ability of the industry in Scotland and south of the border to withstand shocks and as such, it would not follow that the comparison was invalid. Moreover, it would not be appropriate to suggest – as other evidence to the Committee may have implied – that the same ratio applied to two quite different models should be interpreted in the same way. The rationale for the comparison has to be properly understood. For example, just because a supermarket has lower margins than a chain of department stores does not mean that it is necessarily less profitable or less attractive from the perspective of the provider of capital. Much also depends on the cost of capital and the sustainability of, or risks to, revenue.

It was certainly useful to have the opportunity to provide a detailed written submission to the Committee on this important issue. In my paper 'Ensuring the Sustainable Financing and Operation of a Public Sector Water Industry', we asked the Committee to bear in mind (page 18) the differences in structure between the private and the public sectors, which render the detailed comparison of financial ratios difficult. We also pointed out (page 20) that there is no universal definition of such ratios. Our remit is both to ensure that the interests of customers are safeguarded and to ensure the sustainability of the finances of the water industry in Scotland. Consequently, we shared comparisons with the Committee, which served to illustrate the extent to which customers in Scotland and south of the border were potentially exposed to operational or legislative shocks.

In this paper, we discussed how, from a customer perspective, it is vital that the water industry – an essential public service – operates on a sustainable footing. In the private sector, the water company needs to be able to access finance on an on-going basis. This ensures that the customer is insulated from the impact of an operational or legislative shock. In the public sector model, the water undertaker should seek to finance its operation and investment in such a way so as to maintain the lowest sustainable price for a given level of service to customers. The 1.0 free cash flow cover of interest that we targeted for the end of the current Strategic Review was designed to protect the interests of customers both now and in the future.

A further important comparison will reinforce the relevance of the comparisons used in the oral evidence to indicate the sustainability of the financing in Scotland and south of the border. This relates to the absolute level of debt and the ability to service that debt. This is what lay behind the financial assumptions included in the advice to Ministers. The only comparison that can be applied equally to both the public and private sector models is a comparison of EBITDA[4] or EBIT[5] with the actual level of debt. This is because debt principal and interest have priority over the payment of dividends.

The view of Ofwat on the maximum prudent level for these ratios is outlined in Table 8.2. The Committee will note that Ofwat does not differentiate between the size of companies or between whether they were privatised or had always been private companies. This is important because the water-only companies did not benefit from any green dowry or the conversion of debt into equity.

Table 8.2: Debt payback ratios: Ofwat target[6]

	Water and sewerage company	Large water only company	Small water only company
Debt payback period (EBITDA basis)	Max 5 years	Max 5 years	Max 5 years
Debt payback period (EBDA[7] basis)	Max 7 years	Max 7 years	Max 7 years

In Table 8.3 we have calculated the debt payback ratios based on the revenue caps included in the advice to Ministers. The table also shows these ratios based on the profile of improvement in efficiency that is currently expected. It is clear that the revenue caps contained in the advice were as low as was consistent with the prudent financing of the industry. The re-profiling of efficiency improvement has more than used up the limited flexibility in the second half of the regulatory period.

Table 8.3: Scottish Water debt payback ratios

Debt payback period in years	2002-03	2003-04	2004-05	2005-06
Strategic Review of Charges:				
EBITDA	5.2	4.9	4.1	4.0
EBDA	7.9	7.2	5.5	5.3
WICS estimates:[8]				
EBITDA	4.8	5.2	4.9	5.2
EBDA	7.0	7.7	6.9	7.5

This is confirmed in Table 8.4. In this table we show the impact of having reduced the revenue required from customers by 5% in the first year of the Strategic Review of Charges. It is clear that Scottish Water would have had to achieve all its targets and that there was no operational shock, for its debt payback ratios to have complied with the Ofwat targets.

Table 8.4: Scottish Water revenue capped at 2.5% (not 7.5%) in 2002-03

Debt payback period in years	2002-03	2003-04	2004-05	2005-06
Strategic Review of Charges:				
EBITDA	6.0	5.7	4.8	4.8
EBDA	9.8	9.1	6.8	6.7
WICS estimates:[9]				
EBITDA	5.6	6.2	5.8	5.7
EBDA	8.6	10.0	8.9	8.6

This analysis demonstrates conclusively that the revenue caps for Scottish Water were set at the lowest level consistent with the potential for efficiency improvement that could reasonably be expected and the overarching goal of ensuring that the finances of the industry were placed on a sustainable footing by the end of the current regulatory period.

The Committee is correct to point out that borrowing should only be used in line with the principles of the Treasury's Golden Rule. It is important to highlight that

4 EBITDA: Earnings before interest, tax, depreciation and amortisation.
5 EBIT: Earnings before interest and tax.
6 Ofwat, Final determinations: Future water and sewerage charges 2000-05; page 151. Table 28: Ranges for critical financial indicators.
7 EBDA: Earnings before depreciation and amortisation.
8 Based on Regulatory Returns.
9 Based on Regulatory Returns.

no extra value has been created for customers as a result of the increase in borrowing beyond the targets set in my Strategic Review of Charges. No new customers were added to the network, no improvements have been made to the environmental and public health performance of the assets and no improved maintenance regime was introduced (beyond those already funded by the Strategic Review of Charges).

8.6 Scottish Executive's response to the Committee's report

The Scottish Executive made two responses to the Finance Committee's report. There was an immediate initial response followed by a letter dated 14 June 2004.

The initial response outlined in general terms some of the measures that the Scottish Executive proposed to include in its Water Services etc (Scotland) Bill. The second response provided more details and dealt with other matters relating to public expenditure.

The Scottish Executive's proposed changes are[10]:

- *"To give Ministers clear statutory duties to set publicly the standards and objectives that Scottish Water should achieve and the principles to be applied in setting charges for customers.*

- *"To transfer the functions of the Water Industry Commissioner from an individual to a small board of non executive experts and a chief executive, to be known as the Water Industry Commission for Scotland.*

- *"To empower the new Commission to set limits on Scottish Water's charges, rather than advise Ministers on them as happens at present, and to do so on the basis of Scottish Water being funded to deliver Ministers' objectives at the lowest overall efficient cost to the customer.*

- *"To set out in statute a transparent process by which the new Commission, working within a policy framework established by Ministers, will consult publicly on proposed charge limits before setting these limits."*

In Section II of this document we examine in detail the changes to the regulatory framework.

10 The Scottish Executive's response to the Finance Committee dated 23 April 2004.

Section 1: Chapter 9
Lessons learned from the Strategic Review of Charges 2002-06

9.1 Introduction

The *Strategic Review of Charges 2002-06* was the first detailed analysis of the performance of the water industry in Scotland. Our Review was handed to Scottish Ministers by the deadline set in the commissioning letter. In November 2001, we received confirmation that the Minister had decided to accept our advice on revenue caps and our other recommendations that were designed to create an environmentally and financially sustainable industry in the public sector.

The Strategic Review of Charges highlighted a number of challenges:

- the need to improve efficiency;
- the potential threat of competition;
- the need to improve understanding of the condition and performance of assets; and
- the desirability of improving the financial sustainability of the industry.

The industry has responded well to all of these challenges and customers can look forward to much improved value for money as a result. Not surprisingly, some stakeholders have criticised the Review and some of the steps that have been taken to meet the challenges highlighted in our analysis.

The areas of criticism have included:

- the process of harmonising charges;
- the increase in fixed charges;
- the industry should have been allowed to borrow more;
- the efficiency targets were unreasonable;
- a lack of clarity in roles and responsibilities; and
- a lack of explanation.

We will address each of these areas of criticism. For each we will summarise the criticism and provide a response. In preparing the *Strategic Review of Charges 2006-10*, we are keen to learn lessons from the criticism that has been made. We do not expect that all stakeholders will like all of the contents of the next Review, but we are keen to improve understanding of our role. The chapter concludes with an outline of some of the changes that we intend to make to our process and to our methods to take account of the comments that we have received from stakeholders.

9.2 Criticisms of the Strategic Review of Charges 2002-06

9.2.1 The process of harmonising charges

Issues raised by stakeholders

There are three main criticisms that have been made about the harmonisation of charges. These are that the process was completed too quickly, that there should not have been harmonisation for non-domestic customers and that there was insufficient communication.

Our response

In the Strategic Review of Charges, we highlighted the impact that harmonisation would have on different types of business. However, we accept that many of those that were adversely affected by harmonisation feel that there was insufficient communication. We believe that Scottish Water, the Scottish Executive and this Office can learn from the perceived lack of communication.

We have reviewed the argument that there should not have been harmonisation for business customers. Our view is that there are two alternatives: the first is to harmonise for all non-domestic customers; the second is to opt for fully cost-reflective tariffs for all non-domestic customers. The first approach is consistent with the pricing of other utility or public good services (for example Royal Mail). It avoids the risk of a ‘post code’ lottery where the price of the water and sewerage service could vary quite dramatically depending on where the customer lives. Fully cost-reflective charges are an option, but could make the service prohibitively expensive for those who live in remote areas. This could also have an adverse impact on smaller businesses located in more urban areas. If a larger customer were to decide on an 'off-network' solution, this could have a dramatic impact on the bills of those customers located in the same water supply zone. We remain convinced that harmonisation for all customers was in the long-term interests of all customers.

We have also reviewed the argument that harmonisation was introduced too quickly. Our analysis suggested that the impact would be less, and would affect fewer customers, if harmonisation was implemented swiftly. This was because the tariff regimes were so different in each of the three authorities. We also consider that it would have been difficult to justify much higher prices to some customers when an identical customer in a different part of Scotland was paying much less. This did not just affect smaller businesses. The following example of a supermarket chain, with large stores located in Dundee, Glasgow and Edinburgh, would illustrate.

Table 9.1 shows the bills that applied in 2002-03 for each of these stores.

Table 9.1: Example of typical bills 2002-03

40mm meter, water volume 13,000m^3, RV = £1,145,000[1]	Dundee	Glasgow	Edinburgh
Total bill	£83,068	£55,515	£37,418
% of Dundee bill	100%	67%	45%

9.2.2 The increase in fixed charges

Issues raised by stakeholders

In the Strategic Review of Charges, we highlighted that cost-reflective prices would be important in ensuring that larger water users chose to maintain a connection to the public system. Some stakeholders have objected to this. One of the objections is that the fixed charges were introduced too quickly and were not communicated sufficiently well. The other objections are different for metered and un-metered customers.

Standing charges were increased for metered customers. Metered customers with relatively low usage will suggest that they should pay for what they use. They assert that this is what happens in other utility services.

A minimum charge was introduced for un-metered customers. The un-metered customer had always paid a fixed sum for the water and sewerage service. The amount depended on the rateable value of the property served. The un-metered customer was therefore objecting to the level of the bill, rather than the fact that the bill did not vary with volume.

Our response

We would again accept that many customers felt that there was insufficient communication of the impact of increasing fixed charges. There are lessons that we can learn. These will be discussed in more detail below.

We have looked again at the issues raised by metered customers. Our view remains that the cost of supply is a function of peak consumption, rather than simply the total consumption. It seems to us that it is appropriate that all connected customers should make a contribution to the maintenance of the water supply and sewerage infrastructure. The increase in fixed charges is consistent with this. To delay the implementation of fixed charges would have been to accept that larger users would continue to make a greater contribution to the costs of maintaining the network.

Our view is that there is little merit in charging for water and sewerage services by rateable value. This means that a small city centre shop might pay more than a much larger shop in a rural area (even though the latter is probably much more expensive to supply). We believe that the minimum charges proposed by Scottish Water and agreed by us were not unreasonable. Many rateable value customers paid less than Band A households.

[1] Customer characteristics are typical of those for a large supermarket based in a Scottish city.

9.2.3 The industry should have been allowed to borrow more

Issues raised by stakeholders

Some stakeholders have argued that if the industry had been allowed to borrow more, then charges could have been kept at a lower level. They will sometimes further argue that it would have been better to borrow more.

Our response

We discussed issues relating to debt in Chapter 7. It is true that borrowing more during the 2002-06 regulatory period could have reduced bills for customers – but only at the expense of higher bills in the future. In effect, customers would have swapped an investment backlog for an increased debt. We can see no merit in increasing debt faster than the economic value of net new assets. This could only make the industry less able to respond to shocks.

9.2.4 The efficiency targets were unreasonable

Issues raised by stakeholders

The unions have consistently argued that both our approach to setting efficiency targets and our assessed scope for efficiency were unreasonable. They argue that comparing performance with England and Wales does not take account of: the industry being in the private sector, the geography and customer base, and the higher level of investment that has been made south of the border.

Our response

Our efficiency assessments take full account of differences in asset and customer bases and geography. The Costs and Performance Reports and the Strategic Review of Charges describe these assessments. We can see no reason why customers should be asked to pay more because the industry remains in the public sector in Scotland. Indeed, given the cost of capital advantage of the public sector, it is possible to argue that bills should be lower on a like-for-like basis in Scotland.

9.2.5 A lack of clarity in roles and responsibilities

Issues raised by stakeholders

Some stakeholders have expressed frustration because no-one seemed to want to take responsibility, nor was it clear who was taking which decisions.

Our response

We agree that there was a perceived lack of clarity. This was due to the nature of the regulatory regime that is in place. This Office has a statutory duty to advise Ministers on the matters to be taken into account and left out of account in setting charges for customers. Ministers can accept this advice, can amend it (and give reasons) or can substitute their own advice (and give reasons). Ministers will commission such advice relatively rarely. The last advice was in 2001. The next advice (if the system does not change) would be due in 2005.

Each year we are required to agree the detailed tariffs that Scottish Water proposes to charge. In proposing these tariffs, Scottish Water has to have taken due account of the advice that has been accepted by Ministers. We have to accept these tariffs if we believe that they are fully consistent with the advice accepted by Ministers. Ministers have no role in the setting of annual tariffs unless Scottish Water and this Office do not agree. While the legislative position is clear, we would accept that it can be difficult to understand that this Office has little decision-making discretion, and that Scottish Water is bound to take account of our advice and yet Ministers cannot easily intervene unless they commission new advice.

Stakeholders should also be aware that any regulated company will, at times, find it convenient to blame its regulator for some of the difficult decisions that it has to take. We would suggest that stakeholders ask why Scottish Water believes it does not have discretion to act. We set targets at a macro level precisely because we do not want to have to manage the operations of Scottish Water.

9.2.6 A lack of explanation

Issues raised by stakeholders

Some stakeholders have commented that they have found our explanations to be incomplete or confusing.

Our response

We tried to document our assumptions, logic and answers as completely as possible in the *Strategic Review of Charges 2002-06*. Given the amount of information that we use and the complexity of the analysis it is difficult to explain each issue as fully as we might like. We had to strike a balance between the detail and length of the *Strategic Review of Charges 2002-06* and the completeness of our presentation of our assumptions, logic and answers. We plan to address this for the next Strategic Review.

9.3 Lessons learned

We are pleased that the *Strategic Review of Charges 2002-06* has stimulated debate about the challenges faced by the water industry in Scotland. The publication of the Scottish Executive's consultation document *Paying for water services 2006-10* is another important step. A large number of cross-subsidies exist between customer groups. Some of these are intentional (for example the link between domestic bills and the Council Tax band of the property and the harmonisation of charges across Scotland). Others have arisen over time and may not now be considered appropriate. Decisions about the appropriateness of cross-subsidies are political and it is not appropriate for either regulators or regulated companies to take these decisions. We look forward to clear guidance from Ministers on this issue.

Similarly, we welcome the strengthening of the regulatory framework for the water industry in Scotland. This will clarify the roles and responsibilities of this Office, Scottish Water and the Scottish Executive. The price-setting process should be more understandable. The establishment of a Commission should also serve to depersonalise regulation and to facilitate more effective communication with stakeholders.

These structural changes will not prevent (indeed they may increase) comments from Scottish Water that its regulator is forcing it to do (or not to do) something. It is certainly not the intention of this Office to dictate to Scottish Water how it should manage its business. We may force Scottish Water to live within a defined budget, but we do not tell it how to live within that budget.

We believe that the *Strategic Review of Charges 2002-06* set a framework that was appropriate and in the interest of customers now and in future. There has been a marked improvement in the industry's efficiency and in its understanding of the assets. We believe that the Review made a significant contribution to encouraging these improvements.

Over the past year we have looked at the advice and the recommendations contained in the Review on three separate occasions: in reviewing Scottish Water's representations (see Chapter 6), in providing evidence to the Finance Committee (see Chapter 8) and in beginning to prepare the *Strategic Review of Charges 2006-10*. On each occasion we have concluded that we would not make any material changes either to the advice or to the recommendations.

However, we do believe that there are a number of steps that we can take to improve the transparency, accountability and perceived proportionality of regulation.

9.3.1 Transparency

Improving process

In July we published *Our work in regulating the Scottish water industry: Setting out a clear framework for the Strategic Review of Charges*. This described in some detail our work plan and all of the information that we collect from Scottish Water. It also provided information about the opportunities for stakeholders to learn more about our work and to ask questions.

We are committed to publishing most of the information that we receive from Scottish Water and all of the tools that we use in our analysis. We will also explain these tools so that stakeholders can understand how they are used.

The work plan for the Strategic Review of Charges also highlights the dates when we will require inputs from Scottish Water and from the Scottish Executive. We hope that everyone will strive to meet these deadlines.

Perhaps the most important part of the process begins with publication of our draft advice/determination at the end of June next year. This will be followed by a period for representations about this answer from stakeholders. Our final advice/determination will be published at the end of November. These prices will take effect from the beginning of April 2006.

Better explaining our approach

We have arranged a large number of stakeholder information days over the period between June 2004 and February 2005. These are half-day sessions when we will explain where we are in completing the Strategic Review of Charges. We hope that these sessions will also provide an opportunity for stakeholders to raise their concerns with us. We will respond to all of the issues that are raised at the stakeholder information days.

The *Strategic Review of Charges 2002-06* was regarded as ministerial advice. It was therefore published only after the Minister had taken his decision. In preparing the *Strategic Review of Charges 2006-10*, we will publish a number of documents, presentations, information submissions and analytical tools. We trust that publishing all of the key inputs to this Review will allow stakeholders to gain a full understanding of both our approach and the final answer.

Ensuring that stakeholders can understand the answer

There are three important ways in which we can ensure that stakeholders can understand the answer. Publishing all of the key inputs to the Review will be important. However, we will also endeavour to present the answer in a way that will allow stakeholders to understand what the answer means for them and for customers as a whole. We will also outline our reasoning and make clear the evidence upon which we have relied to come to our answer.

We also note comments from some commentators that they found that our reasoning in the last Strategic Review of Charges was not complete. The next Strategic Review of Charges will provide sufficient information for all of the major findings of the Review to be replicated.

Providing opportunities for comment

There are three main ways in which we will provide stakeholders with opportunities to comment. These are the stakeholder information days; the publication of our proposed methodology; and the period for representations after publication of the draft advice/determination. Each of these will play a valuable role in allowing us to hear stakeholders' views. We encourage stakeholders to use these opportunities.

In the work plan for the *Strategic Review of Charges 2006-10*, we also outline our plans for two further consultation documents. These consultations will discuss firstly the general principles that we should consider when issuing a license to a new entrant to the Scottish water industry and secondly the detailed license conditions that should be placed on Scottish Water's retail business. These two consultations will depend upon the progress of the Scottish Executive's proposed framework for competition in the water industry in Scotland.

9.3.2 Accountability

Explaining the role of this Office and other stakeholders

We believe that the Scottish Executive's proposals to strengthen the regulatory framework in Scotland will help improve both actual and perceived accountability. The establishment of a Commission should depersonalise regulation – a Commission arriving at a joint decision is always likely to be considered more accountable than an individual with a similar power.

The proposal to give the Commission the power to decide prices subject to ministerial guidance is welcome. This will ensure that authority and responsibility are aligned. The responsibility for each decision will be clear and unambiguous. This should be more comprehensible than the previous system where Ministers had to take decisions on the basis of a Commissioner's advice.

Providing opportunities for comment

As explained above, we have included a number of opportunities for stakeholders to learn about our work and to make their representations to us. We believe that this will also play an important role in improving the accountability of this Office.

9.3.3 Proportionality

There has been a concern from some quarters (principally Scottish Water in its first year and the trade unions) that our analysis lacked proportionality. The assertion was that we had adopted regulatory tools from south of the border and had blindly applied these in Scotland, taking little or no account of the maturity, geography and asset base or the public sector nature of the water industry in Scotland. Similarly there was a concern about how quickly we had asked Scottish Water to narrow the efficiency gap.

We accept that we perhaps did not explain in sufficient detail all of the steps that we had taken to ensure that Scottish Water was treated fairly. These steps included (but are not restricted to): changes to the models to reflect the large number of small assets in Scotland; the provision of £200 million of spend to save from customers; and the fact that we did not adjust Scottish costs to reflect the lower service levels offered in Scotland. We are confident that we took full account of all of the factors that could have disadvantaged Scottish Water.

We did explain our method for assessing how quickly Scottish Water should close the efficiency gap in some detail. Looking back, it might also have been helpful to re-emphasise the importance of spend to save in making our rate of catch-up less demanding.

In the *Strategic Review of Charges 2006-10*, we will pay particular attention to issues around comparability of companies, costs and levels of service. We will seek to set targets that are proportionate and to take full account of factors that would both increase or reduce the targets.

9.4 Conclusions

We believe that the *Strategic Review of Charges 2002-06* set a framework that has contributed to a significant improvement in the value for money that customers have received and can expect to receive in the next several years. Scottish Water is now well on its way to reducing its operating costs on a like-for-like basis by some £145 million. This alone will mean that customers' bills will be some 15% less than they would otherwise have been.

The Review was also the catalyst to significant improvements in the industry's understanding of its customers and its assets. This is a solid foundation for further improvements in value for money in the next regulatory period.

We are pleased that the *Strategic Review of Charges 2002-06* has played a part in reversing years of deteriorating efficiency in the water industry in Scotland. However, we recognise that there are a number of areas where we could and should improve.

We have adopted the principles of the Better Regulation Task Force and intend that this next Review will be as transparent as possible. We hope that our actions and the proposals by the Scottish Executive to strengthen the regulatory framework will also ensure that our Office is seen to be accountable to stakeholders.

Section 2: Chapter 10
Powers of determination

10.1 Introduction

In Section 1 we discussed the current framework for regulation of the water industry in Scotland. In this section we look at proposed developments in the regulatory process that are likely to impact on the *Strategic Review of Charges 2006-10*.

Perhaps the most significant of these developments are proposals by the Scottish Executive to strengthen our powers and structure. Currently, our powers are 'advisory' in that we provide advice to Ministers and it is then up to Ministers to make decisions. Our powers are also currently vested in one individual, the Water Industry Commissioner. The provision of appropriate advice is the sole responsibility of the Commissioner.

The Water Services etc (Scotland) Bill, introduced in June 2004, proposes a number of important changes to the regulatory framework, including granting our office 'powers of determination' and allowing Scottish Water a right of appeal to the Competition Commission. The Bill also proposes the establishment of a Commission to regulate Scottish Water, instead of regulation by an individual.

In simple terms, the 'power of determination' means the legal right of the regulator to set prices and other targets. Such powers carry responsibilities for the regulator, especially when establishing charge levels. These powers are exercised within a framework established by law and ministerial guidance. To counterbalance these powers, the regulated company would expect to have the right of appeal to an independent body, normally the Competition Commission. The Water Services etc (Scotland) Bill proposes introducing this right of appeal for Scottish Water.

In this chapter we discuss the background to these proposals. We describe in detail what powers of determination are and how they are exercised by other regulators. We outline other sectors' regulatory structures and explain the Scottish Executive's proposals in the Draft Bill. Finally we identify the possible implications of the proposals for our *Strategic Review of Charges 2006-10*.

10.2 Current legal framework

Under current arrangements, we have a statutory duty to advise Ministers on the matters to be taken into account and left out of account in the setting of charges to customers. Ministers therefore commission this advice, either in the form of a Strategic Review or in ad hoc requests. Ministers can accept this advice, amend it (and give reasons), or substitute their own advice (and give reasons). The advice and any amendments are to be published by this Office. It is up to Ministers to decide an appropriate level of funding for the industry. There is no formal appeal mechanism for Scottish Water.

In addition to advising on overall funding levels, each year we are required by law to agree the detailed tariffs that Scottish Water proposes to charge customers. In proposing these tariffs, Scottish Water should take account of the advice agreed by Ministers. Our role is to ensure that the tariffs in total will generate the required level of revenue and that any proposed change in the balance of revenue from different customer groups is appropriate and consistent with the advice.

10.3 Ten principles

In Chapter 6 we discussed the events leading up to the development of the 'ten principles'. The 'ten principles' were agreed by the Scottish Executive, the Commissioner and Scottish Water.

Principle 9 states:

> *The Executive will investigate setting up a prospective appeal mechanism to the Competition Commission.*

Principle 9 committed the Scottish Executive to consider an appeal route for Scottish Water to the Competition Commission. This was seen as a possible necessary addition to the existing regulatory framework which would allow the management of Scottish Water to challenge targets that they considered to be inappropriate.

The Water Services etc (Scotland) Bill, introduced in June 2004, proposes the creation of a water industry commission with powers of determination and a right of appeal for Scottish Water to the Competition Commission.

This proposed right of appeal for Scottish Water would ensure that challenges to regulatory decisions can be assessed in an objective and independent way. It would also help reinforce the requirement on our Office to ensure that regulatory decisions are made in a robust, auditable and transparent manner.

10.4 Finance Committee Inquiry

In Chapter 8 we discussed the inquiry by the Finance Committee of the Scottish Parliament. Part of its remit was to investigate accountability, looking at the role of the Water Industry Commissioner, and relationships with Scottish Water, the Scottish Executive and local authorities.

In evidence to the inquiry we suggested that economic regulation for the water industry in Scotland should work in broadly the same way as for other utilities. Under this model, Ministers would provide clear guidance on social, environmental and public health priorities and the regulator would then, through a transparent process, set maximum prices that can be levied on customers. Scottish Water would have the right of appeal on regulatory decisions to the Competition Commission. We said that this very clear process would reduce uncertainty amongst stakeholders on roles and responsibilities.

The Finance Committee published its findings in April 2004. The report included a recommendation to strengthen the regulatory regime:

> **88. The Committee believes that an improved structure and support for the WIC is needed to ensure independent regulation and transparency across the industry. Modelled on some of the English and UK regulators, an Office of the Water Industry Commissioner, including a non executive membership, could provide greater accountability and continuity for the Scottish water industry. Consideration should be given to whether certain decisions should be taken by the WIC in the context of advice from Ministers rather than the reverse.**

In our response to the Committee's findings, we said:

> *We agree. We have been advocating for some time that, in the interests of customers, the water industry in Scotland should be regulated in a way that is more transparent and accountable, consistent with UK regulatory policy.*
>
> *We welcome the proposals announced by the Minister in response to the Finance Committee report with regard to the creation of a regulatory board structure with non-executive membership. This will strengthen the regulatory function and increase transparency to the benefit of all customers.*
>
> *A regulatory board would be an invaluable source of advice and support to the executive staff of WICS. It may also help to depersonalise the interactions between WICS and Scottish Water. We had sought to gain some of the long-term benefits of a regulatory board by establishing an advisory panel. This panel includes experts from the legal, regulation, business, academic and public service worlds. Unfortunately, owing to budgetary constraints, we have had to disband this Panel for the time being.*
>
> *In particular we would advocate a move to a regulatory regime, more consistent with UK regulatory policy, in which the regulatory board sets price caps and determines charges based on guidance from Ministers. This will improve clarity of roles within the industry and help ensure that customers can benefit from the potential advantages of the public sector model.*

The Scottish Executive gave an immediate initial response to the Committee's report, followed by a letter dated 14 June 2004.

The Scottish Executive outlined its proposal to establish a commission with determinatory powers in its Water Services etc (Scotland) Bill.

The Scottish Executive's proposed changes are set out in detail later in this chapter. Before reviewing these proposals, it is helpful to examine the components of UK regulatory policy which the Scottish Executive is proposing to introduce to the water industry in Scotland.

10.5 Powers of determination

Broadly, powers of determination are the powers vested in regulators to determine the charges levied by regulated companies. At a more detailed level, powers of determination are more far-reaching than simply the setting of charges. Typically, regulators' powers would also include areas such as:

- imposing conditions of appointment on industry participants;
- resolving disputes between industry participants and customers;
- determining the basis and extent of charges; and
- dealing with the insolvency or failure of an industry participant.

These are wide-ranging powers, which will impact directly on industry participants and customers. As a counterbalance to powers of determination, regulated companies have a right of appeal. There are two avenues for appeal – the Competition Commission and judicial review.

10.5.1 Appeal to the Competition Commission

If a regulated company disputes the regulator's price limits, it can require the regulator to refer the determination to the Competition Commission.

The Competition Commission is an independent public body with the technical, economic and legal expertise to adjudicate in disputes between companies and their regulators. Its involvement helps to ensure that the charge-setting process, carried out in the knowledge of a possible referral, is robust and transparent. If a case is referred to them, their decision will be binding. This check also ensures that regulators' decisions are subject to appropriate expert scrutiny.

Following a referral, the Competition Commission would initiate a process of determination of the price limits. Its functions are set by statute. Neither the regulator nor the water company requesting referral can narrow down or broaden out the Commission's functions. The matters that the Commission must take into account are the same as those taken into account by the regulator.

The Competition Commission's conclusions are binding. Until the Commission makes its decision the regulator's original determination stands. In practice, this means that all companies have to implement the determination of price limits set in the regulator's determination until such time as the Competition Commission has reached a conclusion.

Once the Competition Commission has completed its inquiry and made its determination, the price limits set by the regulator are replaced. The new limits would apply for the remaining years of the determination period.

10.5.2 Judicial review

In the UK, the exercise of 'powers' by a public body is subject to judicial review. In principle, the purpose of judicial review is to protect citizens from abuse by ensuring that the powers and duties of government and other public bodies are exercised consistently and within their legal bounds. This procedure can be seen therefore as another means by which a company – or any third party with some interest in the water industry – could appeal against a regulator's decision.

Judicial review is the mechanism used by the courts to review the way in which government Ministers or departments, local authorities and/or other public bodies exercise their powers and carry out their duties. It is concerned with reviewing not the merits of the decision that has led to the complaint, but the decision-making process itself.

The procedure may be invoked by a company, an individual or even an interest group that considers itself to be adversely affected by misuse of a public body's powers, provided there is no other suitable means of redress available and the application is made to the court promptly.

In addition to bringing judicial review proceedings, interested parties may intervene and be heard on applications for judicial review. Judicial review is being used increasingly as it is seen, often through well-publicised cases, as an effective means of control of government and other public bodies.

10.6 Implications for regulatory process

Regulators have a duty to act fairly and to take into account all relevant matters when making a decision. They also have to exercise powers reasonably and lawfully; and meet legitimate expectations for proper procedure. An example is the requirement to give full written reasons for decisions.

If a party thinks that one or more of these duties have not been met in arriving at a decision then it can ask for judicial review of the process or refer the decision itself to the Competition Commission.

In Chapter 9 we discussed the lessons learned from the *Strategic Review of Charges 2002-06*. We believe that the proposed introduction of powers of determination is consistent with the clear process that we have established for the *Strategic Review of Charges 2006-10*.

The proposed introduction of a right of appeal will also further reinforce the requirement to record carefully the information that we use to determine charges and our rationale for the detailed assessments and decisions that we have to make. We believe that the proposed changes to this Office and its powers, and our clear framework for the *Strategic Review of Charges 2006-10*, will improve the robustness and ease of understanding of the Review.

10.7 Review of other regulators and their powers

Regulators have duties and powers that are defined in statute and through licences that govern the operation of the companies.

In large part, the powers available to regulators reflect their duties. Most UK regulators have powers of determination, reflecting the fact that their duties might otherwise have been exercised by Ministers. These powers are wide-ranging and involve more than just fixing charges. We can illustrate this by examining Ofwat's other duties and powers.

Ofwat's general duties are those of the Director General as specified in the Water Act 1989 and the Water Industry Act 1991. Under these Acts, the Director General has a duty to:

- ensure that the functions of the companies are properly carried out;
- ensure that the companies can finance the carrying out of their functions;
- protect the interests of existing and potential customers;
- promote economy and efficiency on the part of the companies; and
- facilitate competition where appropriate.

In carrying out its statutory duties, Ofwat has a variety of powers. For example, the 1989 and 1991 Acts grant powers to:

- impose conditions when appointing water or sewerage undertakers[1];

[1] Water and sewerage companies and water only companies require an Instrument of Appointment, which gives the legal right to provide water and sewerage services. Ofwat is responsible for granting, modifying and renewing Instruments of Appointment.

- enforce compliance with provisions made in the company Instruments of Appointment;
- resolve disputes on whether standards of performance required by statute in the provision of water services and sewerage services have been met;
- determine the terms and conditions for non-domestic supplies where agreement cannot be reached between the parties;
- determine the terms on which cross boundary sewers discharge into a company's sewer where agreement cannot be reached between the parties;
- determine the interest rate applicable where money is borrowed to finance the provision of a water main or where sums of money have been deposited with the company as security for an obligation;
- request a special administration order, ie an order directing that the company be managed by a person appointed by the High Court;
- require undertakers to give and take bulk supplies (on the application of a water undertaker).

The most visible power exercised by Ofwat is the power of price determination, but it also has many other powers. The powers available to this Office will obviously be different and more limited, reflecting the public sector nature of the industry.

10.8 Regulatory structures

Other regulators have either already adopted Board structures or are moving towards them. Where they have been set up, Boards not only depersonalise regulation (through collective responsibility) but also bring relevant professional experience to bear on the work of the regulator (through non-executive directors with relevant professional expertise).

For example, the Gas and Electricity Markets Authority determines strategy and makes major policy decisions for Ofgem to implement. It comprises a Board of five executive and nine non-executive members, appointed by the Secretary of State. The non-executive directors have backgrounds in commercial, financial, public sector and energy industry sectors.

In the water sector in England and Wales, the Water Act 2003 made provision for the Water Services Regulation Authority to be set up. This Board will replace the Director General of Water Services. However, it will not be established until after Ofwat's current price review, due to be completed later this year.

In the communications sector, Ofcom's Board provides strategic direction for Ofcom. It comprises three executive and six non-executive directors. The non-executive directors have backgrounds in telecommunications, news media, journalism, property and economics.

The Office of Rail Regulation is led by a Board appointed by the Secretary of State for Transport. It has five executive and six non-executive directors. The non-executive directors have backgrounds in law, regulation, finance, customer service and railways.

10.9 Proposals for Scotland

The proposals in the Water Services etc (Scotland) Bill 2003 mirror some of the features of UK regulatory policy described above.

Its objective is to strengthen the regulatory framework for the water industry, and to ensure that there is a robust and transparent regime that operates in the interests of all customers. The Bill includes measures to improve the accountability and transparency of the regulator, including replacing the current individual Water Industry Commissioner with a corporate body, the Water Industry Commission for Scotland. The Bill then goes on to give the Commission powers of determination over Scottish Water's charges.

The provisions in the Water Services Bill introduce a range of measures to establish reasonable limits on the new Commission's powers of determination, including:

a) the statutory requirement to take guidance from Ministers;

b) the right of Scottish Water to appeal to the Competition Commission following a determination; and

c) the possibility of an interested party initiating a judicial review of the Commission's exercise of powers.

In detail, the Bill establishes the following steps in the determination of charges in the water industry.

- Within the limits and controls established by the policy framework set by Scottish Ministers, the Commission is first required to assess the total revenue that Scottish Water needs. This assessment must be based on the principle that the revenue raised by the scheme of charges, when taken with the borrowing and grants available to Scottish Water from Ministers, is sufficient for the purpose of enabling Scottish Water to perform its core functions effectively. In calculating this limit, the Commission must take account of all circumstances that might have a bearing, either positive or negative, on Scottish Water's ability to meet its obligations.

- The Commission will then determine maximum charge limits for Scottish Water's charges for its core functions. These charge limits will be based on the objectives set by the Minister and will reflect the cost to Scottish Water of maintaining its whole infrastructure across the country, irrespective of the actual cost of serving individual customers which will vary, for example, with distance from treatment works. The amounts determined would apply in relation to such periods as the Scottish Ministers may specify.

- In parallel, the Bill requires the Commission to consult on the process by which it carries out charge determination. The Commission must consult the Scottish Ministers, Scottish Water and any other person that might help in defining the optimal charges policy. The Commission then makes and publishes a draft determination, after having taken into account the representations received. In doing so, the Commission must have regard to any complaint made to the Commission regarding the proposed scheme by such time as the Scottish Ministers may specify. The Commission must send a copy of the provision to the Scottish Ministers, Scottish Water and every water services and sewerage services provider. It must also publish details of every departure from the charges scheme initially proposed by Scottish Water.

- Following this consultation, the Commission will make a final determination of charge limits. The determination might make different provisions for different groups of customers or categories of services. Similarly to the current set up, a charge determination will be made for a medium-term period[2].

The Bill also provides for determinations to be reviewed, in advance of the date set for the next determination, if there is a substantial change in circumstances which results in a significant increase or decrease in the amount of revenue Scottish Water requires to carry out its core functions.

As discussed above, an important component of the new Bill is the introduction of a right of appeal to the Competition Commission on decisions made by the Commission.

Under the proposals, once the Commission has set maximum limits for Scottish Water's charges, Scottish Water will be required to propose a detailed charges scheme, which must adhere to the maximum charges set out in the Commission's determination. It is expected that Scottish Water will be asked to propose charges schemes on an annual basis.

An important feature of the proposals is that Scottish Water will no longer have discretion to make agreements with specific customers about their charges. Instead, all charges must be made by reference to a charges

[2] The first one is expected to cover charges in 2006-10.

scheme. Any departures from the charges schemes will have to be specifically authorised by the Commission on the basis that the charge-payer has taken actions that reduce the cost to Scottish Water of providing services to them. The Bill makes specific provision for existing agreements to be continued until they expire, and provision that they may not be renewed or extended.

Once the Commission approves a charges scheme, Scottish Water must make arrangements to allow any person to inspect the scheme at any reasonable time and to obtain a copy of the scheme or part of it on payment of a reasonable fee, as it may determine. Scottish Water also needs to publicise those arrangements and publish a summary of these schemes.

10.10 Impact of the proposals

Effective regulation is in the interests of customers and industry stakeholders. The proposals outlined in the Bill provide an opportunity to strengthen further the regulatory process in the water industry in Scotland. The creation of a Water Industry Commission for Scotland to take collective responsibility for the Commissioner's functions is in line with the restructuring proposed for the water regulator in England and Wales, and is consistent with the Board structures already established for other regulators. Like other sectors, the Commission will benefit from a high level of relevant experience from its future non-executive members.

Proposals regarding the introduction of powers of determination contain some material differences from the equivalent powers in England and Wales. From the standpoint of customers, the most significant difference involves Scottish Water's ability to borrow money. In most other regulated sectors, companies are freely able to access debt, subject only to conditions in the debt markets. Most other regulators do not have to adjust prices to take account of constraints on new borrowing.

The current proposals for Scotland would mean that Scottish Water is still subject to public expenditure limits. It is possible that in the future, it may be prudent for Scottish Water to borrow more than Ministers may be able to allocate in public expenditure. This would lead to an increase in customer charges beyond that included in the *Strategic Review of Charges 2006-10*.

10.11 Conclusion

The proposed measures to strengthen the regulatory framework for the water industry in Scotland will clarify the roles and responsibilities of this Office, Scottish Water and the Scottish Executive. The price-setting process should be more understandable. The establishment of a Commission should also serve to depersonalise regulation and to facilitate more effective communication with stakeholders.

The proposals in the Bill should also help ensure that challenges to regulatory decisions can be assessed in an objective and independent way. They will reinforce the requirement on our Office to ensure that regulatory decisions are consistent with the recommendations of the Better Regulation Task Force, ie that they are transparent, accountable, consistent, targeted and proportionate.

Section 2: Chapter 11
The core/non-core split

11.1 Introduction

This chapter explains the implications of the change in our remit under the Water Industry (Scotland) Act 2002. The Act introduced a distinction between Scottish Water's core and its non-core activities, and established that our remit should cover only Scottish Water's core activities and promote the interest of customers being provided with those activities. The chapter also outlines why the separation of core and non-core business is in the customer interest. Separation should ensure that customers of the core business pay only for the services they use.

In this chapter we examine:

- developments under the former water authorities;
- the findings of the Transport and Environment Committee's Inquiry in 2001;
- concerns expressed in the *Strategic Review of Charges 2002-06*;
- changes in legislation – the Water Industry (Scotland) Act 2002;
- further changes in legislation proposed by the Scottish Executive;
- potential impact of non-core activities on core customers in Scotland;
- protecting core service customers;
- separation of core and non-core activities in Scotland; and
- issues arising.

11.2 Developments under the former water authorities

In 1996, three regional water authorities were established in Scotland[1]. Through their own initiative, and in response to customers, the authorities developed activities beyond the traditional provision of water and removal of waste water. During the years that followed, there was mounting pressure on the authorities to control increases in bills to customers. By developing non-traditional activities, the authorities hoped to generate income that could offset, in part, increases in bills to customers for water and sewerage services.

Some activities provided a 'value-added' service to existing commercial customers. By providing services such as waste minimisation and consultancy for businesses, the authorities hoped to retain customers that might otherwise be tempted to find alternative ways to obtain water or treat waste water. The income from any customers who left the network would be lost, and could have an adverse impact on bills for customers who remained on the network.

The authorities also recognised that in many cases they could make more effective use of their assets by providing additional services, such as offering services using their scientific laboratories.

In 2001, Ministers announced the potential merger of the three authorities to form Scottish Water. At that time, the authorities continued to see opportunities in the growth of non-traditional activities. They felt that such growth could be used to attract commercially minded individuals into the business, helping cultural change that would ultimately benefit all customers through improved efficiency.

11.3 Findings of the Transport and Environment Committee's Inquiry in 2001

In 2001, the Scottish Parliament's Transport and Environment Committee Inquiry into water and the water industry recognised the issues around the distinction between core and non-core business, but sounded a note of caution.

The Committee's report stated:

> *"In supporting the authorities' ability to invest in commercial ventures the Committee wishes to emphasise the importance of continuing to focus on*

[1] Local Government etc (Scotland) Act 1994.

> *core activities and fulfilment of statutory duties. The Committee notes that while different authorities indicated in evidence that they intended to fund ventures in different ways, (e.g. West of Scotland Water Authority from charges and East of Scotland Water Authority from efficiencies) in the absence of any new income stream being identified, the money would ultimately be sourced from general funds.*
>
> *Consequently, it is certainly possible that customers already facing steep charge increases to fund necessary capital investment would not welcome also paying to fund speculative ventures. There is inevitably a dilemma in this difficult situation. However, the cost of not developing and retaining business must also be reckoned with – reducing industrial revenue due to lack of flexibility could lead directly to increased domestic charges greater than those required to fund the modest investment aspirations set out by the authorities.*
>
> *The Committee recognises that the water authorities will require increased freedom to invest in commercial ventures. However, it supports the view that the water authorities should continue to focus on their core duties and should 'ring-fence' new ventures to ensure that they do not become a drain on resources."* [2]

We supported the view that Scottish Water (or the authorities at the time) should be able to develop new business, particularly if this limited the risk of losing revenue from the largest commercial customers. But we also strongly supported the protection of the core business and its customers.

11.4 Concerns expressed in the Strategic Review of Charges 2002-2006

In the *Strategic Review of Charges 2002-06*, we reviewed the experience of the privatised water and sewerage companies in England and Wales in generating additional sources of business from non-core activities. We also looked at the development of non-core activities in Scotland and their success or otherwise.

We concluded that investment in new business by Scottish Water would need to be approached very cautiously. There was insufficient evidence that it had the potential to be of significant benefit to customers for the risks to be justified. These risks were not only the capital that is invested (either in cash or in capital investment) in any new venture; there were also risks associated with the diversion of management time away from the main task at hand – improving relative efficiency and developing more cost-reflective tariffs. Even if the profits of such ventures could have reached several million pounds, the benefits would be limited relative to the successful achievement of efficiency targets.

11.4.1 Experience of non-core activities in England and Wales

The Review examined the situation south of the border, where customers' money is not used to fund non-core business. Shareholders of the privatised companies bear all of the financial risk. Customer charges for the core business are retained within that core business and there can be no question that a failed venture outside the core business could impact on customer charges in the core business.

The economic regulator, Ofwat, regulates the revenues of the core business and determines the allowable return on capital for the assets employed in the core business.

Equally, even a successful venture by the privatised company will not immediately impact upon customers' bills. Only if the Board of the company were to decide to reduce the return allowed by the regulator, because of the profit generated elsewhere, would this happen. In this way, shareholders take all of the risk associated with non-core activity and, quite equitably, take all of the earned return. Ofwat does not in any way regulate the activities of the privatised companies outside the core business (except in the most extreme case where an activity could threaten the company's ability to fulfil a core business licence condition).

[2] Scottish Parliament, Transport and the Environment Committee, 9th Report 2001, Report into Water and the Water Industry, SP paper 362.

11.4.2 Risk of distraction

In the *Strategic Review of Charges 2002-06*, we said that it was easy to be distracted by thoughts of profits from non-core activities. This can overlook the extent of the sustainable revenue that needs to be generated and the costs incurred (particularly in the early years). We said that our role required us to monitor any non-core business activities that had the potential to affect revenue.

We concluded that it was important that customers in Scotland enjoyed similar protection to customers south of the border. The financing for any new ventures in Scotland, whether a small opportunity for a start-up with potential for organic growth, or an acquisition, ultimately has to be obtained from customers of the core business or from the taxpayer. Our view was that commercial opportunities should be carefully assessed, because even if the venture appeared to generate a return relatively quickly, there may be hidden costs (such as costs to exit the business), which could adversely impact on customers' bills in the future.

We recommended that there should be an accounting separation of Scottish Water's activities into at least three areas: retail water services; networks and treatment; and non-core business activities. We noted that there would not necessarily be any need for regulation of non-core activities of the authorities after an accounting separation. This would require a clear arm's length relationship between the core and non-core businesses. It would also have to be clear that the public expenditure constraints on the core business were not unduly tightened because of support provided to a non-core activity.

Ministers accepted our recommendation for accounting separation.

11.5 Changes in legislation – the Water Industry (Scotland) Act 2002

Section 70(2) of the Water Industry (Scotland) Act 2002 defines what constitutes Scottish Water's core and non-core functions. In effect, it provides that Scottish Water's core functions are the duties and powers conferred on Scottish Water by any enactment, including the 2002 Act itself, the Sewerage (Scotland) Act 1968 and the Water (Scotland) Act 1980. It excepts from this category functions exercised by Scottish Water by virtue of the powers conferred by subsection 25(1) of the 2002 Act, along with any functions conferred by subsection 25(2) that are exercisable in relation to 25(1). It is these functions which are the non-core functions.

In practice this means that Scottish Water's core functions comprise a wide range of defined powers and duties, all of which are set out in statute. Its non-core functions amount to a general power to act without the specific authority of statute, but subject to the condition, at 25(1), that any such action is "not inconsistent with the economic, efficient and effective" exercise of the core functions. In brief, if an activity is defined by and carried out under the authority of any Act it is core, if not it is non-core.

11.5.1 Scottish Water's commercial powers

Section 25 of the 2002 Act as a whole provides Scottish Water with the statutory basis on which to pursue its core and non-core functions through a variety of commercial means. It provides that Scottish Water can:

- form or promote (whether alone or with others) companies (within the meaning of the Companies Act 1985);
- subscribe for share or loan capital of any person;
- guarantee the discharge of any obligation (whether financial or not) of any person;
- form partnerships, enter into arrangements or agreements and co-operate in any way with any person; and
- enter into a contract with any person for the provision or making available of assets or services, or both (whether or not together with goods) whether by Scottish Water or by that person.

As regulator, we will monitor the core activities carefully to ensure that customers' bills are not impacted by any non-core initiatives pursued by Scottish Water.

11.5.2 Change to the remit of the Water Industry Commissioner

At the time of the *Strategic Review of Charges 2002-06*, our remit, as defined in statute, was to look after the interests of customers of the three former water authorities. Legislation did not distinguish traditional, or core, activities from non-traditional, non-core, activities. Our Review covered the whole of the authorities' activities, expenditures and income.

As noted above, in 2002 our remit changed. The legislation now defines the Water Industry Commissioner's role by reference to Scottish Water's core functions.

The Water Industry (Scotland) Act 2002 sets out the Commissioner's role:

> *The Commissioner has the general function of promoting the interests of customers of Scottish Water in relation the provision of services by it in the exercise of its core functions.*[3]

Also, the Commissioner's advice on charges is to have regard to:

> *the economy, efficiency and effectiveness with which Scottish Water is using its resources in exercising its core functions.*[4]

This is a useful clarification, as it brings Scotland into line with England and Wales where the regulator's responsibility is in regard to customers of the 'appointed' (licensed) business, which can be broadly considered as equivalent to Scottish Water's core functions.

Our focus on core functions will require us to:

- define core functions at a detailed level;
- monitor the allocation of Scottish Water's costs between core and non-core functions; and
- ensure that core and non-core revenues reflect the allocation of costs.

11.6 Further changes in legislation proposed by the Scottish Executive

The Water Services (Scotland) Bill, which is currently before the Scottish Parliament, includes provisions for the creation of a Water Industry Commission to succeed the office of the Commissioner.

The Commission would have the additional functions of:

- determining the limits to be placed on the charges that Scottish Water levies customers for the provision of its core functions; and
- administering a regime to license the provision of retail water and sewerage to non-domestic customers.

Scottish Water's retail activities would fall to be licensed under provisions in the Bill that would empower Ministers to require the creation of a separate subsidiary to perform these activities. The Bill also provides that were such subsidiary to be created, its functions would be treated as non-core. We discuss the wider implications of this in Chapter 3. However, the Bill could well have implications for the way we define and separate core and non-core.

Effective regulation of the core business will depend on clear definitions of the activities included in the core business and robust allocation of costs to those activities.

11.6.1 Differences with England and Wales

The Water Industry Act 1991[5] sets out the duties, rights and powers of the companies in England and Wales. They have a duty to provide water and sewerage

[3] Water Industry (Scotland) Act 2002 section 1.
[4] Water Industry (Scotland) Act 2002 section 33.
[5] Amended by the Competition and Service (Utilities) Act 1992.

services, although the legislation does not define exactly the limits or the extent of the core business.

In addition to the legislation, companies in England and Wales operate under licence. Licence Conditions F and K require that a company reports separate accounts for the appointed business[6] as if its sole business is to be a water undertaker (including sewerage). A company must also ensure that there is no cross-subsidy between the appointed business and other activities of the appointed business and associated companies. Any dealings must be at arm's length. The appointed business must be ring fenced (that is, kept separate from any impact arising from the non-appointed business) to ensure that it has sufficient rights and assets to carry out its regulated activities or to be passed on to a special administrator.

This requires Ofwat to have a view on what forms the core business. Its approach is set out in its Regulatory Accounting Guidelines (RAG). RAG 3.05 includes the following definitions:

"Appointed Business

Definitions

- The Licence separates the activities of an Appointee into:
  - the appointed business which is defined to be the regulated activities of the Appointee; and
  - the non-appointed business which is defined to be the non-regulated activities of the Appointee.
- Regulated activities are defined in Condition A of the Licence to be the "functions of" and the "duties imposed on" a water and sewerage undertaker by the Water Industry Act 1991. Regulated activities are consequently those activities that are necessary in order for an Appointee to fulfil the functions and duties of a water and sewerage undertaker.
- In general, non-regulated activities are activities for which either the water and sewerage undertaker is not a monopoly supplier (for example, the sale of laboratory services to external organisations) or the activity involves the optional use of an asset owned by the Appointed Business (for example, the use of underground assets for cable television)."

The guidelines provide further details, by way of examples, on the division between appointed and non-appointed activities based on these criteria (although Ofwat notes that the examples are not intended to be exhaustive).

- "Appointed activities:
  - water supply (including bulk supplies and large user customers)
  - sewerage
  - sewage treatment and disposal
  - management and holding of protected land
  - supply of non-potable water
  - rechargeable work for which Appointee is monopoly supplier
  - conservation
  - recreation and amenity uses of those waters and lands which the Appointee employs for the purposes of water supply, in order to comply with the Water Act 1989, for example rambling.
- Non-appointed activities:
  - sale of non water and sewerage services to third parties including the Environment Agency, for example laboratory, computing, billing, engineering, meter reading, support and transport services
  - plumbing services
  - consultancy

[6] The appointed business is that which holds an Instrument of Appointment, the terms of which are set out in the licence.

- external sales of energy
- billing commission
- stores sales to third parties
- rechargeable work for which Appointee is not monopoly supplier
- recreation and amenity uses of non appointed assets in conjunction with those waters and lands which the Appointee employs for the purpose of water supply, beyond the duties imposed by the Water Act 1989, for example water skiing and restaurants."

Ofwat's guidelines also recognise that ambiguities may arise:

- "Despite these definitions, exceptions will arise to the general rules. (For example, trade effluent treatment is regulated under the Licence but undertakers are not monopoly suppliers of this service.) The consistency and accuracy of the definitions applied will become increasingly important as appointed companies continue to diversify. Appointees are therefore required to detail in the notes to the regulatory accounting information their definition of appointed and non-appointed businesses adopted for the purposes of those accounts. This note should be, as far as is practicably possible, in line with the guidance provided above.''

We expect to draw heavily on Ofwat's work as we too seek to ensure that there is a detailed definition of core activities.

11.7 Potential impact of non-core activities on core customers in Scotland

The current absence of a clear ring fence between the two types of activity could mean that the pursuit of non-core activities would have an impact on customers of the core business. These customers might find that their bills were higher because they had to subsidise non-core activities or that the risk in the business was greater, leading to higher costs and hence higher bills. This may be the situation in Scotland today.

Customers can be affected in other ways. A lack of clear separation between the core and non-core activities of Scottish Water could have an impact by:

- poor allocation of costs between core and non-core activities, leading to cross-subsidy; and
- management being distracted from the core business in pursuing non-core business.

Cost must be allocated correctly between core and non-core business because it can affect bills. Core customers should broadly pay charges that reflect the cost of providing a service to them; the higher the cost, the higher the bill. If costs incurred in non-core activities are allocated to the core business, customers of that core business will meet those costs in addition to the costs of the core business.

It is therefore in customers' interests that there is a clear separation of core and non-core business and that any interaction between these two areas is carefully recorded and monitored. For example, a member of staff of the core business could do some work for a non-core business. The cost of the person's time spent on non-core business should properly be paid to the core business.

The extent of such hidden cross-subsidies could be significant. Scottish Water's management has to spend time on both core and non-core activities. The core business is by far the largest part of Scottish Water and we would expect management to spend most of its time on the core. However, non-core business could take up a not insignificant proportion of time in relation to its overall value to the business. We believe that robust accounting separation will ensure that there is a proper focus on core activities.

Non-core activities might in the future provide a source of retained profit for Scottish Water. This profit could have been used to lower charges within the core business. However, in the shorter term there is a risk that non-core business will not generate a profit and will increase bills for core customers. The separation of activities does not mean that the owner could not choose to use future profits to subsidise customers of the core business.

It would therefore appear to be clearly in the customer interest for there to be an appropriate level of separation between core and non-core activities.

11.8 Protecting core service customers

Public ownership of the water industry in Scotland should provide some degree of protection. In particular, all non-core activity must satisfy the test that its pursuit by Scottish Water is not inconsistent with “the economic, efficient and effective exercise” of Scottish Water’s core functions. In addition, under section 56 of the 2002 Act, Ministers are required to give Scottish Water directions as to how it conducts its non-core activities.

We believe that it is useful to examine whether customers of the core business of the water and sewerage companies in England and Wales have been successfully insulated from the risks of non-core activities.

11.8.1 The core water and sewerage business is ring fenced within its group

In England and Wales, the ring fence protects the assets and resources of the regulated business from other activities of the Group. This is achieved by means of Licence conditions and accounting rules. Licence Condition F requires Directors of the appointed business to provide an annual statement that the ring fenced business has adequate financial and managerial resources to carry out the regulated activities. Moreover, if the appointed business (or an associate business) is proposing to embark on any activity which might be material to its ability to carry out regulated activities, it must notify Ofwat.

11.8.2 Accounting separation

The company’s auditors and Reporters will scrutinise the accounts of the ring fenced business. They ensure that the accounts are consistent with the Regulatory Accounting Guidelines.

These audited regulatory accounts are in addition to the holding company accounts. Moreover, the Reporter scrutinises all of the regulatory information provided to Ofwat.

11.8.3 Transfer pricing rules

Transfer pricing is the price charged for goods and services (including staff and consultancy) traded between the core and non-core parts of the holding company. Ofwat examines the price paid for goods and services to ensure that price limits are set on the basis of the actual costs of providing water and sewerage services to customers and not costs inflated by cross-subsidy. This is of particular importance where the core water and sewerage business overpays. This could be an attempt to move money to the non-core to take it out of reach of the regulator. This would benefit shareholders at the possible expense of customers.

The rules for transfer pricing are set out in Ofwat’s Regulatory Accounting Guidelines RAG 5.03. The guiding principles are that:

- the appointed business pays a fair price for services and products received;
- companies are based on market price or less – where no market exists, transfer prices are based on cost;
- market testing is used to establish market prices for supplies, works and services provided to the Appointee; and
- costs are allocated in relation to the way resources are consumed.

Ofwat requires the licensed companies to demonstrate, through the application of these principles, that there is no cross-subsidy.

Ofwat monitors carefully the companies' compliance with the guidelines. Where there is an area of concern about a particular company, Ofwat sends a team to examine transactions between the appointed business and other group companies.

11.8.4 Has the regime in England and Wales been effective?

Ofwat strictly enforces ring fencing, accounting separation and transfer pricing. The license conditions and Ofwat's monitoring regime fully protect customers from any trading problems in the companies' unregulated activities. The regime is especially important in England and Wales because of:

- the creation of multi-utilities, eg United Utilities;
- ownership of water and sewerage companies by other concerns, eg Thames Water by RWE; and
- diversification, eg South Staffordshire Water and Severn Trent Water.

The effectiveness of the ring fence was clearly demonstrated when the collapse of Enron, which owned Wessex Water, had no impact on core business customers.

The ring fence has protected the interests of customers and provided stability for the core business in the event of takeovers, mergers and diversification.

11.9 Separation of core and non-core activities in Scotland

The effect of the Water Industry (Scotland) Act 2002 is to require us to take steps to identify separately core and non-core activities for regulatory purposes. It is likely that implementation of the Water Services Bill will require a separation of the non-domestic retail function.

In order to ensure that we promote the interests of customers of the core business, we will have to take the following steps:

- clearly identify core activities;
- establish a set of rules governing transfer pricing between the core and non-core activities; and
- ensure that reporting is consistent with these rules and that this reporting is subject to rigorous monitoring and audit.

11.9.1 Definitions of core activities

We have begun to identify core and non-core activities. Our regulatory information returns will be updated to reflect this understanding. This will impact on information about costs, assets, customers, the investment programme and financing. Our initial activity definition is set out in Table 11.1.

Table 11.1: Definitions of core activies

	Retail	Non-Retail
Core	• Retail contract management & systems • Customer information systems • Customer account management (key account management) • Customer meter reading • Customer billing • Customer revenue collection • Customer debt collection • Customer debt write-off • GMS appropriate to billing, complaints etc. • Metering • Disconnection notification	• Abstraction, treatment, storage, conveyance & distribution of potable water • Conveyance, treatment & disposal of sewage including public septic tanks • Quality control • Call centre for interruptions, quality problems, flooding • Customer information systems • GMS appropriate to interruptions, flooding, and infrastructure etc. • Supply pipe repair • Supply installation • Physical disconnection • Communication/education of flush/don't flush, reservoir safety
Non-core	• Added value services – insurance, bottled water etc. • Non-domestic septic tank emptying • Communication/education • Tailored service consultancy • Grey water • General engineering consultancy • Film location services • Forestry	

11.9.2 Regulatory accounting

We have begun work to introduce regulatory accounts for Scottish Water. Regulatory accounts use standards, breakdowns and definitions designed to allow the regulator to fulfil his functions. They are used in most regulated utilities in the UK. These regulatory accounts will ensure that we are able to monitor effectively the separation of core and non-core activities.

We have set out draft tables and definitions, consistent with regulatory accounting, for Scottish Water to report its operating costs. These separate core and non-core business, and retail and wholesale activities. We will continue to discuss our requirements with Scottish Water with a view to agreeing final versions of these tables by the end of 2004.

We will need to produce further tables and definitions covering areas such as the balance sheet, cashflow, assets and investment. This work will have to be complete by the end of this year so that Scottish Water can prepare its second draft business plan on this basis.

An important area of work in introducing regulatory accounts will be the definition of transfer pricing rules. We would expect that these rules would be broadly similar to those used by Ofwat.

11.9.3 Monitoring

We currently receive a monthly RAB (resource accounting and budgeting) report from Scottish Water. This sets out Scottish Water's income and expenditure against the budget for the period. It makes a broad distinction between core and non-core operating costs and reports costs recharged to new non-core operations. This has allowed us to keep track at a high level of core/non-core costs but does not provide the necessary detail to examine individual activities. These tables will have to be updated so that they are consistent with the regulatory accounts. Our other information returns will also require significant updating.

11.9.4 Independent audit

We introduced an independent auditor (called a Reporter) at the start of 2004 to check that all of the information Scottish Water returns to us is accurate. The role of this auditor is in most respects the same as that of the reporter for the companies in England and Wales. The remit of the Reporter is described in detail in Chapter 6.

Part of the function of the Reporter is to examine and provide an opinion on the detailed accounting information provided by Scottish Water in its annual regulatory return. In particular, we ask the Reporter to comment on Scottish Water's cost allocation systems that would underpin any accounting separation.

Once we have implemented the accounting separation, we will use the Reporter to monitor transfer pricing rules and report any issues.

11.9.5 Business plans

Scottish Water will produce a draft and then a second draft business plan to inform the *Strategic Review of Charges 2006-10*. The plans will be submitted to us and to the Scottish Executive in October 2004 (first draft) and April 2005 (second draft). The framework for these plans is described in Chapter 14. We expect Scottish Water to set out its assessment of non-core activities and its plans for pursuing non-core business in these documents. The business plans will help identify issues that need to be resolved for accounting separation to go forward successfully and we will work with Scottish Water to find solutions.

The information presented in the final version of the business plan will be accounting separation, transfer pricing and regulatory accounts initiatives.

11.10 Issues arising

11.10.1 Assessing performance

Separating core and non-core business will help us to regulate Scottish Water effectively. If it is undertaken properly, and costs are allocated correctly, we will be able to make judgements based on a truer picture of the core business that we regulate.

Our introduction of regulatory accounts will facilitate our monitoring and comparison of Scottish Water's performance against that of the appointed businesses of the water companies in England and Wales. Separation of Scottish Water's core business will allow us to do this without having to make adjustments for non-core activities. Regulatory accounts will ensure that we compare levels of cost in England and Wales and in Scotland on a like-for-like basis.

An appropriate separation of core and non-core business will therefore increase comparability in the benchmarking process and result in more robust efficiency targets. The greater degree of clarity will benefit the regulator in monitoring progress towards achieving the efficiency targets. It will also increase regulatory transparency and so give the management of Scottish Water a greater degree of comfort that the efficiency targets are realistic and achievable.

11.10.2 Issues for Scottish Water

Scottish Water is aware of the potential difficulties of accounting separation. It is already implementing systems for allocating costs that would appear to be well-suited to identifying core and non-core operating costs. We are hopeful that these systems will be sufficiently robust to meet the requirements of accounting separation. Extending the allocation of core and non-core activities to the remaining areas of financial reporting is likely to be a significant challenge for Scottish Water.

Scottish Water also faces choices – to what extent should it maintain existing non-core business, and in what areas might it be prudent to pursue new non-core activities.

Perhaps the most significant issue, however, is how Scottish Water will ensure that its policies on non-core activities, and especially the pricing of those activities, are immune from successful challenge from other firms under competition law.

11.10.3 Reporting obligations of Scottish Water

Scottish Water compiles annual accounts that are consistent with guidance provided by the Scottish Executive. This guidance is broadly consistent with UK accounting standards. These ‘statutory accounts’ require no separation of core and non-core activities.

The separation of core and non-core activities is likely to affect the annual statutory accounts. This separation will increase the reporting obligations of Scottish Water to both its regulator and to the Scottish Executive. This burden will, however, be no greater than that faced by companies south of the border.

11.10.4 Funding of non-core activities

Financing of any non-core activity by Scottish Water will currently have an impact on the core business, at least in the short run. This is because the start-up resources could have been used to improve the level of service to customers or the environmental or public health compliance of Scottish Water. If the non-core activity continues to be cash negative, this could consume additional cash that could have been used by the core business and, within the current framework, would have an adverse impact on customer charges or taxpayers. Since the taxpayer only provides access to borrowing, ultimately this cash outflow will have to be funded by customers of the core business until sufficient retained profit is available to remunerate initial investment. Customers therefore have a clear interest in ensuring that there should not be investment in any non-core activity that impacts on the level of service or charges to customers of the core business.

If separation of core and non-core activities is to be implemented effectively, it will be important for both Scottish Water and the Scottish Executive to have decided how non-core activities will be financed. It should not, however, be at the expense of customers of the core business.

11.11 Conclusion

Core business in England and Wales is ring fenced and customers’ bills are not affected by non-core business activities. We welcomed the changes in the 2002 Act because we believed that there should be the same level of protection for customers in Scotland. It remains our view, expressed in the last Strategic Review, that non-core business is intrinsically risky, and that the focus of Scottish Water should stay on core activities.

The introduction of accounting separation of core and non-core activities will help ensure that customers in Scotland enjoy the same protection as those in England and Wales. It will also serve to focus attention on the nature and scale of non-core activities, which should help Scottish Water make informed decisions about its non-core activities. The improvements to cost allocation that will be driven by the regulatory accounts will also help Scottish Water to understand its core costs better. This should help accelerate progress on efficiency.

Implementing accounting separation is not a simple matter, and we will need to work closely with Scottish Water to ensure that it is successful. This is in the interests of all customers.

Section 2: Chapter 12
Introduction of a framework for retail competition

12.1 Introduction

Regulation of the water industry in Scotland continues to evolve and improve. In the previous two chapters we discussed two proposed developments that will strengthen the regulatory process: the introduction of determinatory powers for the new water industry commission and the separation of core and non-core functions for Scottish Water.

In this chapter we look at a third major development that is planned for the water industry in Scotland: the introduction of a framework for retail competition. We explain the proposed changes in detail and look at the likely implications for customers. We also look at the impact of the proposals on Scottish Water: in particular, the implications for the structure of Scottish Water, the way in which it operates and how it is regulated.

The Water Services etc (Scotland) Bill includes provisions requiring the Water Industry Commission to introduce and administer a regime to license retail competition for 'non-household' (business and commercial) customers. Subject to the Scottish Parliament approving these provisions, we propose that the licensing regime should be in place in Scotland by April 2008.

Prior to that date, we expect that the Scottish Executive will require Scottish Water to establish a subsidiary to manage its 'non-household' retail activities, which the Commission will license from the outset. In these circumstances, we expect that retail competition will have an impact on the whole of the period covered by the next Strategic Review of Charges.

12.2 Background to the proposed competition framework in Scotland

The Competition Act 1998 came into force in March 2000. This brought UK competition law into line with European law. The Act contained two prohibitions. Chapter One prohibits anti-competitive behaviour by companies and prevents them from entering into agreements that distort, restrict or prevent competition. Chapter Two prohibits a company from abusing its dominant position.

The Office of Fair Trading (OFT) enforces the Competition Act 1998. This power is shared with the economic regulators of utilities. For example, Ofgem has concurrent powers for the enforcement of competition law in the gas and electricity industries throughout Great Britain and Ofwat has similar powers with respect to the water and sewerage industry south of the border.

These regulators may use either competition powers or sector-specific powers to investigate the behavior of a company. Information gathered using sector-specific powers can be used for the purposes of an investigation under the Competition Act 1998 and vice versa.

The OFT has sole responsibility for the enforcement of the Competition Act 1998 in the water and sewerage sector in Scotland.

'In the market' competition has multiple service providers competing for individual customers. Service providers, who may be licensed, can enter and exit the market. Customers will choose their supplier based on the mix of price and service that they feel best meets their individual needs. Market participants succeed or fail depending on their ability to meet customers' needs better than their competitors.

'For the market' competition exists where service providers compete for the right to supply a service. A good example of 'for the market' competition is the water industry in France. In France, water and waste water services are the responsibility of individual local authorities. They seek to enter into an agreement with a water and sewerage service provider who will operate, maintain and upgrade the network and provide a service to customers in that area. These contracts are time limited.

Customers do not have choice in this model. They must pay the price for the service level that will be governed by the contract.

Another example is out-sourcing. A business might feel that it is not capable of carrying out a particular function efficiently. It can overcome this by outsourcing the function to have another party do it for them. It is possible to outsource several parts of the supply chain to different contractors. This has been the model adopted by some other utilities, including water companies. Contractors can carry out the capital programme, operations and customer service. The experience of other sectors also shows that this model can co-exist with 'in the market' competition.

In the *Strategic Review of Charges 2002-06*, we conducted a detailed review of the structure of the industry. We concluded that 'in-the-market' competition was only likely to exist in the retail (customer services and billing) market. The experience of the energy markets demonstrated some of the potential benefits and also highlighted some of the potential pitfalls. These pitfalls can probably be effectively managed through the licensing system.

A paper by Professor Stephen Littlechild[1], electricity regulator at the introduction of competition in that market, examines retail competition in electricity. He notes that the largest customers benefit from better prices, value-added service and terms. The benefits for smaller customers include bundling with other utilities and more flexible tariffs and payment terms. He also notes that a dynamic retail market exerts upward pressure on wholesalers to be more responsive and efficient. It was clearly possible to consider 'for-the market' competition in other areas but this would be a decision for the industry.

Our analysis suggested that there were three principal risks faced by the water industry in Scotland as a result of the Competition Act. It was clear that the industry needed to improve its efficiency and allocate its costs accurately. We also believed that it would be better to establish a clear framework for how competition would work in the Scottish water industry. Inaccurate cost allocation or inefficiency represented a risk because it could lead a customer or a supplier to accuse Scottish Water of breaching the prohibitions under the Act. Likewise, we considered that a framework, which made it clear what Scottish Water was allowed to do and clarified the policy position on environmental and public health protection, could also reduce the risk of a challenge under the Act.

12.3 The introduction of competition to the water industry in Scotland

The Scottish Executive launched an initial consultation[2] on the development of competition in the Scottish water sector in June 2000. It set out possible changes to the statutory framework for the water industry in Scotland, including allowing new entrants to have access to the public water and sewerage networks. It proposed establishing a licensing regime for new entrants, which would be overseen by the Water Industry Commissioner.

In our response to this consultation we commented that:

> "Competition in the water industry has the potential to bring significant benefits to customers, and will be in addition to the benefits brought by customer service and economic regulation. Comparative competition within the water industry has shown to be one way of providing the impetus for improvements in efficiency and customer service. The introduction of real competition would provide further pressure and potential rewards, thus leading to better value for money for all customers."

In October 2003, the Scottish Executive published a consultation on a draft Water Services (Scotland) Bill. It set out proposals for the introduction of limited competition to the water industry in Scotland. In the consultation, the Scottish Executive recognised that competition can bring benefits to customers through choice and encouraging efficiency, keener prices, greater customer responsiveness, innovation and improved standards.

The consultation discussed two key aspects of the proposed competition framework:

'Common carriage' — where Scottish Water would use its system of water mains to carry water treated by a competitor to the competitor's customers, or where it would use its sewers to carry waste water from a competitor's customers to the competitor's treatment works.

[1] Stephen C Littlechild, Competition in Retail Electricity Supply, Journal des Economistes et des Etudes Humaines, September 2002.
[2] "Managing Change in the Water Industry", A Consultation paper. Published by the Scottish Executive on 15 June 2000.

Retail competition — where Scottish Water would have sole responsibility for treatment and distribution on the public networks. It would treat water or waste water for a third party 'retailer' and would distribute it to or from the competitor's customers using the public networks. In such cases the role of Scottish Water would differ from its present role of supplier in that while it would continue physically to supply water and sewerage services, it would do so on behalf of the retailer. It would be the retailer rather than Scottish Water who would have the direct commercial relationship with the customer.

The consultation noted that common carriage could encourage competition in the provision of water and waste water treatment services by enabling third parties to develop new treatment facilities that relied on the public networks to supply and serve their customers. There would also be scope to use retail competition as a means of providing customers with more choice in how they pay for water and sewerage services. The Executive added, however, that these options also posed a range of risks.

The key elements proposed in the consultation were as follows:

Prohibiting common carriage on the public networks

The Executive proposed that common carriage on the public networks should be prohibited. It believed that there would be risks to public health and the environment posed by third parties having access to the networks. It believed this would compromise Scottish Water's ability to manage the network safely. It suggested that the consequences could include contamination of the public water supply, interruption to the supply and damage to the public infrastructure, threatening public health. Similarly, on the waste water side, there could be pollution, including sewage flooding, interruption to the supply and again damage to the public infrastructure – threatening public health and the environment.

The Executive concluded that these risks to public health and the environment would outweigh any foreseeable benefits that might arise from competition in treatment services. It decided, therefore, in the interests of safeguarding public health and the environment, that the regulatory framework should be revised to preclude the possibility of anyone other than Scottish Water using the public networks to carry out the physical supply of water or sewerage services.

Prohibiting retail competition for households

The Executive also set out its view that retail competition posed risks for households. It held that these risks arose from the nature, and impact on customers, of the current arrangements by which households pay for water and sewerage charges. In particular, it highlighted the link between charges and the Council Tax band of the property served and the discounts applied (for example to single adult households). The aim of this arrangement is to provide that charges broadly reflect ability to pay.

The Executive reasoned that there is no feasible means by which the range of discounts could be retained. Consequently, there is a serious risk that retail competition for households could mean new entrants to the market 'cherry picking' high-banded properties, leaving low-banded properties and those attracting discounts to be served by Scottish Water. This would reduce Scottish Water's revenues, leaving it little option but to increase charges to those customers who remained with it.

It concluded that it would be unlikely that competition would develop in a manner that would benefit all customers. It decided that the regulatory framework should also preclude the possibility of there being retail competition in the household sector.

Licensing retail competition for non-household customers

The Executive proposed to introduce a licensing regime to ensure that the 'non-household' retail market would be opened to competition in an orderly way. Anyone wishing to provide retail water services or sewerage services would be required to apply for a licence. In order to ensure that there was a level playing field, the retail subsidiary established by Scottish Water would also have to apply for a licence.

In our response to the consultation, we broadly supported the Executive's proposals on the introduction of retail competition for non-household customers.

We were pleased to see that the Executive proposed that all service providers (including Scottish Water's retail subsidiary) would be licensed. We believe this is necessary to provide protection for customers, to create a level playing field for service providers and to reduce the likelihood of a challenge under the Act.

We considered that in the absence of a threshold that the market was sufficiently large to encourage new entrants into the market. New entrants may include companies that provide retail energy and telecommunications services, water and sewerage companies, and smaller specialised water and waste water services companies. We noted that we were aware of companies that have expressed an interest.

Most importantly, we were pleased to note the proposed structural changes to Scottish Water. This is likely to improve Scottish Water's understanding of its costs. We believe that this could improve the efficiency of both the retail and the wholesale businesses and would be to the benefit of all customers.

12.3.1 Provisions in the Water Services etc (Scotland) Bill

Following the consultation, The Water Services etc (Scotland) Bill[3] was introduced before the Scottish Parliament in June 2004.

The key provisions in the Bill are as follows:

- Prohibitions on common carriage and on the provision of water and sewerage services to households by anyone other than Scottish Water – effectively ruling out the possibility of competition in these respects.

- A regime, to be introduced and administered by the Water Industry Commission, which will license 'providers' of retail water and sewerage services to non-household (ie business or commercial) customers, effectively permitting competition in this respect, subject to the control and supervision of the Commission.

- A power for Ministers to require Scottish Water to establish a separate retail business – effectively establishing Scottish Water's retail business as a 'provider' that will be subject to the same licensing regime as all other 'providers' of water and sewerage services.

As a result of the planned creation of Scottish Water's retail subsidiary, Scottish Water will have two main roles. Firstly, it will sell water and sewerage services to retail entrants to the market on a wholesale basis. This will involve the treatment and delivery of water to the premises of the retailers' customers. It will also involve the removal, treatment and disposal of waste water. Secondly, it will continue to provide water and sewerage services to household customers.

Initially, Scottish Water's retail subsidiary will be the sole supplier for all non-household customers. It will buy water and sewerage services wholesale from Scottish Water.

12.3.2 Timetable for the provisions

Our proposed timetable for the introduction of licensing of retail competition is subject to the Water Services etc (Scotland) Bill being approved by the Scottish Parliament. Subject to that approval, and to Ministers requiring the creation of Scottish Water's retail subsidiary, we propose to license the retail subsidiary with effect from April 2006. Thereafter the key dates would be:

- November 2007 – potential entrants can apply for licences,

- April 2008 – retail competition starts.

From experience in other utilities[4], the introduction of competition in the utility sector can be logistically complex. The drafting of appropriate licences and the

[3] Scottish Parliamentary Bill 23.
[4] See *Strategic Review of Charges 2002-06*, Section 3: Chapter 12, page 129.

development of computer facilities to maintain a central database of customers and their supplier will all require significant time and resources. It will therefore be important to ensure that this Office has sufficient resources to meet the proposed timetable.

12.4 Implications of the provisions for the Strategic Review of Charges 2006-10

One of the key challenges for the *Strategic Review of Charges 2006-10* will be to set a reasonable wholesale and retail price. This Review will set retail tariffs not only for household customers, but also for the 'non-household' sector. In effect this will require us to decide the appropriate cost and profit of a retailer (ie the difference between retail prices and wholesale prices). This is likely to continue into the next regulatory period.

When retail competition was introduced into the energy market, regulators continued to set a limit for retail prices for a period after the introduction of competition. Regulation of retail prices until competition is properly established is important as it will help to ensure that there is an orderly, sustainable market.

12.4.1 Charge limits versus revenue caps

The commissioning letter for the *Strategic Review of Charges 2006-10*[5] asks us to set 'charges limits' rather than 'revenue caps'. This is a welcome development from the *Strategic Review of Charges 2002-06*. A revenue cap allows the balance of revenue between customer groups to be altered and also for tariffs to be increased to reflect the loss of part or all of a customer's business. Scottish Water should seek to reduce costs to counter any fall in revenue. However, under a revenue cap Scottish Water could seek to increase tariffs to non-competitive customers to maintain its revenue. This would clearly not be in the customer interest.

A charge limit can prevent such rebalancing. It limits the increase in a particular tariff rather than the increase in revenue (all of the prices multiplied by all of the services provided).

12.4.2 Transparency and cost allocation

The level of the wholesale price is critical. If it is too high, new entrants will not be able to cover their costs and consequently will not enter the market. If it is too low, the core business of Scottish Water would suffer and retailers could make excessive profits.

We have outlined a very detailed work plan for the *Strategic Review of Charges 2006-10*[6]. Our work plan takes full account of the need to set the wholesale price and explain our reasons in some detail. We are also seeking to involve stakeholders so that all interested parties can understand how we set the wholesale price.

This is important for the following reasons:

- New entrants will need reassurance that Scottish Water is not able to subsidise or offer favourable terms to its new retail entity in order to retain customers. Without this reassurance, new retailers will be discouraged from entering the market or may challenge the incumbent under competition law.

- If the wholesale price is not properly set, there will be an unintended cross-subsidy either to or from non-household customers in the new competitive market – at the expense, or to the benefit, of Scottish Water's household customers.

The factors that we will take into account in setting the wholesale price will be described in detail in the third of our publications describing our work in completing the *Strategic Review of Charges 2006-10*, which is due to be published in September 2004. However, they are likely to include:

- the allocation of costs within Scottish Water:
  - between the core and non-core elements of Scottish Water (see Chapter 11);
  - between Scottish Water and its new retail entity:
- a review of transfer prices.

5 Letter from the Minister for Environment and Rural Development, Ross Finnie, MSP, dated 26 May 2004 to Alan Sutherland, Water Industry Commissioner for Scotland.
6 *Our work in regulating the Scottish water industry: setting out a clear framework for the Strategic Review of Charges 2006-10*, July 2004.

12.4.3 Licensing

Significant preparatory work and consultation with stakeholders will also be required if the Commission is to be able to issue a licence to Scottish Water's retail subsidiary. We are proposing a two-stage consultation process. The first consultation, which will cover the principles to be included in licences, will run from April to July 2005. There will then be a second consultation, covering the draft licence conditions for Scottish Water's retail subsidiary, which will run from October 2005 to January 2006.

Our early thinking about the licensing regime would suggest that the licence will need to:

- define the service to be provided;
- set out expectations for behaviour by market participants;
- govern participation in the market;
- govern relationships between:
  - wholesaler and retailer,
  - retailer and customer,
  - regulator and retailer (particularly the provision of information to the regulator);
- allow for regulatory intervention;
- provide a vehicle for enforcement, sanction or ultimately removal of the licence and expulsion from the market.

We also recognise that water and waste water services are very important for most non-household customers. They will wish to be reassured that retailers are fit and proper to provide the services. We are therefore beginning to consider the scope of our consultation on the process for issuing a licence. Some of the criteria we suggest are likely to include the following:

- Financial – do they have the financial resources to enter the market and compete sustainably?
- Managerial – do they have retail/utility experience?
- Technical – do they have access to the tools for the job?

12.5 Conclusions

The proposals announced by the Scottish Executive for the introduction of retail competition could be an important step in improving the regulatory framework of the water industry in Scotland. Clear separation of the costs of the retail activities is likely to help improve the efficiency of the industry. This will benefit all customers.

Section 2: Chapter 13
Trade effluent charging

13.1 Introduction

In Chapter 11 we explained that the Water Industry (Scotland) Act 2002 changed our remit to promoting the interests of customers of the core business. In the *Strategic Review of Charges 2002-06*, we advised Scottish Ministers on the revenue caps that should apply to the industry in Scotland. These revenue caps included core and non-core activities. Scottish Water prepares a scheme of charges consistent with the advice that has been approved by Scottish Ministers. This Office will approve the proposed tariffs, provided that they are consistent with the advice.

Trade effluent is a special case. To date, tariffs for trade effluent have not been included in a scheme of charges and we have not played any role in regulating them. Instead, Scottish Water, exercising powers under section 29(3)(j) of the Sewerage (Scotland) Act 1968, has set these charges. In practice this has meant that the total amount raised from customers in trade effluent charges has been limited to the difference between the agreed revenue cap and the amount raised from the tariffs approved in the scheme of charges.

The provisions of the Water Services etc (Scotland) Bill 2004 provide for the Water Industry Commission to determine charges for all of Scottish Water's core services. As trade effluent is a core activity of Scottish Water, trade effluent charges are within these provisions. Consistent with that approach, the Bill provides for the repeal of section 29(3)(j) of the Sewerage (Scotland) Act 1968, thereby removing Scottish Water's power to set trade effluent charges separately.

Against that background and in light of the Ministers' requirement that we manage the Strategic Review of Charges in anticipation of the Bill becoming law, the Review will set charge limits for the reception and treatment of trade effluent.

In 2004-05, Scottish Water expects trade effluent revenue to be almost £30 million. This is illustrated in Table 13.1.

Table 13.1: Trade effluent revenue by size of customer[1]

Total trade effluent charges paid by customer	Number of customers	Total trade effluent revenue
>= £250,000	22	£11.7m
< £250,000	103	£9.3m
< £50,000	281	£5.1m
< £10,000	889	£2.4m
< £1,000	1,210	£0.2m
Total	**2,505**	**£28.7m**

Trade effluent charges are an important source of income. We will need to understand how they are composed so as to ensure that future charges are set in a manner that is consistent with the statement on the principles of charging that Ministers will set for the period 2006-10 and which determine the approach that we will take in setting charge limits and approving annual charges schemes.

The Water Services etc (Scotland) Bill 2004 requires the Ministers' statement on charges to be based on all charges being harmonised across Scotland. Further, the Executive's consultation paper *Paying for water services* proposes, subject to any particular requirements of Ministers, that harmonised charges for a particular group should be set to recover as closely as possible the fixed and variable costs of serving that group. We agree with these aims, but recognise that it will be difficult first to understand existing cross subsidies and second to adjust charges to trade effluent customers so that they reflect Scottish Water's costs.

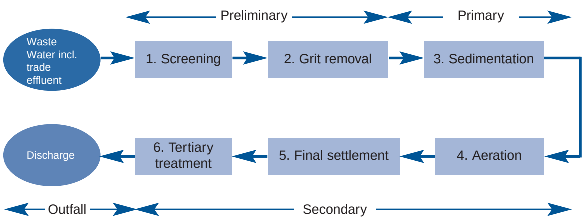
In this chapter we discuss what trade effluent is, how it is regulated now in England and Wales, and the reasons why regulating trade effluent charges would be in customers' interests. We also describe how Scottish Water calculates charges for trade effluent customers.

13.2 What is trade effluent?

Waste water is collected in the public sewer network and conveyed to treatment plants. Figure 13.1 shows the various stages of waste water treatment before the water is discharged to the environment.

[1] Scottish water response to WIC22: period to 31 March 2004.

Figure 13.1: Waste water treatment processes



There are three types of waste water: surface water draining to sewers, foul sewage and trade effluent.

Surface water refers to the rainwater that drains from roofs, yards, pavements, roads and so on.

Foul sewage refers to waste water (either domestic or non-domestic customers) from toilets and washing facilities (sinks, wash basins, showers, baths, etc).

Trade effluent is liquid waste from industrial or other commercial activity. It covers a wide variety of liquid waste, including:

- waste chemicals, including oils;
- liquid process wastes;
- detergents;
- condensate water from compressed air installations;
- cooling water;
- biodegradable liquids;
- wash water;
- liquid wastes or wash waters, other than domestic sewage, discharged using sinks, basins or toilets; and
- contaminated mine or quarry water.

Trade effluent is more difficult to treat and can represent a hazard. Businesses must have the consent of the sewage company before discharging trade effluent into public sewers. This is important because an unauthorised discharge could affect the operation of the sewerage system and threaten the environment and public health. The authorisation to discharge is called a consent.

Sewerage companies set consents at levels appropriate to:

- protect the sewerage system, treatment works and the personnel involved in their operation;
- prevent the generation of explosive, flammable and poisonous gases in the sewerage system;
- prevent sewer blockage;
- prevent hydraulic overloading of the sewerage system;
- ensure that mixed sewage (surface water, foul sewage and trade effluent) can be treated effectively and economically at the receiving sewage works; and
- ensure that the products of wastewater treatment in the form of effluent and sludge have no detrimental effect on the environment[2].

Scottish Water is responsible for managing discharges to sewer by customers. It has a legal duty to identify and manage trade effluent customers. Scottish Water will usually review a consent only once every two years unless the customer writes requesting a review. However, Scottish Water will monitor discharges regularly to check that the consent is appropriate and that the discharges are compliant with the consent.

13.3 Current regulation of trade effluent

The responsibility of Scottish Water for trade effluent is defined under the Sewerage (Scotland) Act 1968 and amendments. In England and Wales, the responsibility of the sewerage companies for trade effluent is defined in the Water Industry Act 1991 (as amended).

2 http://www.envirowise.gov.uk/envirowisev3.nsf/textkey/MBEN4PBHR3

As we explained above, charges for trade effluent in Scotland are currently not regulated. They are limited only to the extent that the revenue cap fixes a ceiling on total revenue and the scheme of charges for regulated tariffs raises an amount lower than the revenue cap. This means that Scottish Water could raise trade effluent charges to compensate for any fall in revenue from other non-core activities not included in the scheme of charges, but included in the original revenue cap. Under the Water Industry (Scotland) Act 2002, we do not have powers to approve charges relating to the collection, treatment and disposal of trade effluent. If a customer disagrees with Scottish Water on issues related to trade effluent, they can appeal to Scottish Ministers or to the Office of Fair Trading.

The provisions in the Water Services etc (Scotland) Bill giving us the power to approve trade effluent charges brings the situation in Scotland broadly into line with that in England and Wales.

In England and Wales, trade effluent customers can appeal to Ofwat. However, the appeals procedure:

- does not cover disputed charges within the sewerage companies' published charges schemes, but does cover disputes about the conditions imposed and charges which fall outside the charges scheme; and
- does not cover appeals against any conditions governing reception, treatment or disposal of 'special category effluent'.

We understand that most disagreements arise over the practical implications of the consent conditions imposed, the timescale in which such conditions must be met, or the costs which meeting the conditions imposes on the customer. In the event of an appeal Ofwat will seek representations from both sides. In most cases the disagreement is resolved by discussion, although Ofwat can issue a decision.

In Scotland we would seek to consult with trade effluent customers, appropriate representative bodies and Scottish Water about the appropriate way to regulate trade effluent charges as part of the determination of charges that we will be required to make.

13.4 Paying for trade effluent

Historically, trade effluent charges in the UK were based on the volume of the discharge. In 1976, the National Water Council and the Confederation of British Industry (CBI) agreed the Mogden formula as a basis for trade effluent charges. This formula sought to increase the cost reflectivity of the charges that were made for the treatment of trade effluent. The formula sets a higher charge for more concentrated effluent that will require a higher level of treatment.

In simple terms, the Mogden formula has four variables:

R (Reception) – this part of the formula is designed to cover the cost of the waste water system. The charge is in direct proportion to the volume of the discharge.

V (Volumetric costs) – this part of the formula covers costs for preliminary and primary treatment. It takes account of the amount of suspended solids in the discharge.

S (Solids costs) – this part of the formula covers costs for treating the sludge resulting from primary treatment. It takes account of suspended solids in the discharge.

B (Biological costs) – this part of the formula covers costs for secondary treatment. It takes account of the organic load in the discharge.

The basic Mogden formula is: Charge = $R+V+\alpha S+\beta B$. It is widely used both in Britain and internationally.

The price of trade effluent will therefore vary depending on the type of discharge. It will also vary depending on the sewerage company's prices for each of the four elements of trade effluent collection and treatment.

Different sewerage companies may want to alter their pricing of individual elements of the formula to reflect the costs of the service they provide.

Scottish Water's trade effluent customers currently pay a standing charge and a volume charge. This is different from the purely volume driven approach used by most companies south of the border.

Scottish Water levies a fixed charge based on the size of the customer's water meter. This charge is designed to reflect the costs incurred by reserving capacity in the sewerage system for the customer. The customer will also pay a volumetric charge that will depend on the volume and strength of their discharge to the sewerage system.

Scottish Water uses two derivatives of the basic Mogden formula to assess the standing charge and the volumetric charge.

To assess the volumetric charge, Scottish Water uses the following formula:

Co = [Ro + Vo + Bo x (Ot/Os) + So x (St/Ss)] x AVD

Where:

Ro = Reception charge (pence per cubic metre)
Vo = Volumetric charge (pence per cubic metre)
Bo = Biological/secondary treatment charge (pence per cubic metre)
So = Sludge/solid treatment charge (pence per cubic metre)

Scottish average sewage system
Os = average settled chemical oxygen demand (COD) for the Scottish sewerage system
Ss = average total suspended solids for the Scottish sewerage system

AVD = Actual volume discharged
Ot = fixed strength of trade effluent discharged
St = fixed strength of trade effluent discharged

The formula assesses the volumetric charge based on the actual volume and strength of the trade effluent discharged. Ro, Vo, Bo and So are all charge factors (pence per cubic metre) set by Scottish Water. The factor Ot/Os reflects the relative COD or biological treatment needed by the trade effluent in comparison to the system average. The factor St/Ss reflects the discharged trade effluent's required treatment of solids relative to the system average.

Scottish Water assesses the standing charge using the following derivative of the Mogden formula:

Ca = [CDV x (Ra+Va) + (Ba x sBODl) + (Sa x TSSl)] x 365

Where:

Ra = Reception charge (pence per cubic metre per day)
Va = Volumetric/primary charge (pence per cubic metre per day)
Ba = Biological/secondary capacity charge (pence per kilogram of load per day)
Sa = Sludge/solid capacity charge (pence per kilogram of load per day)
CDV = Consented daily volume according to the trade effluent consent
SBODl = Settled biochemical oxygen demand load according to the trade effluent consent
TSSl = Total suspended solids load according to the trade effluent consent

This formula assess a standing charge that reflects the customer's agreed access to the sewerage network and treatment process.

Most of the sewerage companies south of the border apply a derivative of the Mogden formula where the charge is primarily a function of the volume and strength of the discharge.

Charge = {R + [(V + BV) or M] + B x Ot/Os + S x St/Ss} x AVD

Where:

R, V, B, S, Ot, Os, St, Ss are the same as defined in the formula to assess the volumetric charge in Scotland (except, of course, that Os and Ss refer to the system average of companies in England and Wales).

In different sewerage company areas, there are variations to the general formula to reflect local circumstances. These include:

BV = Additional volume charge if there is no biological treatment
M = treatment and disposal where effluent goes to a sea outfall[3]

Some companies include a standing charge 'R' that favours large-volume trade effluent customers. All of the companies appear to impose a minimum charge varying from between £79 and £257.25 a year.

Our initial review of the charging structures south of the border suggests that only United Utilities will base charges on the costs of reserving capacity. In the United Utilities area, the customer can choose either a volumetric or reserved capacity-based method of charging. As with Scottish Water, the reserved capacity method includes both a standing charge and a volumetric element.

We can see merit in making a proportion of the charge paid by the customer depend on the capacity de facto reserved in the sewerage system by the agreed consent. This should allow Scottish Water to manage its assets more effectively. It would also seem appropriate that the larger irregular user of the sewerage system should meet the opportunity costs incurred by Scottish Water in not being able to connect other properties to the sewerage network because of previously agreed consents.

We intend to look at the costs associated with trade effluent in more detail to understand whether the formulae used by Scottish Water are appropriate and, if so, whether the balance between the tariffs for each element of the formulae is broadly cost reflective.

13.5 Competition for trade effluent customers

Unlike other water and sewerage services, trade effluent treatment is not a monopoly business. Competition can arise in two forms: on-site treatment (where a company treats its effluent before discharge and consequently lowers its bill by discharging a lower strength effluent), or by allowing a third party to collect and dispose of its effluent. The economies of scale and scope that are enjoyed by a sewerage undertaker are likely to tend to limit both forms of competition.

Subject to the requirements placed on us in the Ministers' statement on charges, we expect, in regulating trade effluent charges, that we will want to be sure that there is a fair allocation of costs to trade effluent and that the price is broadly reflective of these costs. We would want to be sure that higher costs were not allocated to foul sewerage or to surface drainage in order to reduce the price of trade effluent. This would further limit the opportunities for competition for trade effluent and would not be in the general customer interest.

13.6 The balance between charges for trade effluent and other sewerage services

We intend to complete a range of analyses in order to assess whether there is an appropriate allocation of costs to the various waste water activities.

The first option that we will use is to compare the price of trade effluent with the price for domestic foul sewage. We would expect that for a given volume of effluent, the only difference in price should relate to strength; likewise, for a given strength of effluent the only difference in the charge should relate to volume.

A second approach will be to compare the balance between sewerage, surface drainage and trade effluent charges in different companies. We will do this by reference to a number of standardised customers. This will allow us to compare the bill that these standardised customers would face in different parts of Great Britain. A comparison of this with relative bills for other services could be informative.

We will also look at the customer base of different companies to understand whether there are factors relating to the mix of customers that impact either on the costs of the sewerage system as a whole or on the costs of treating effluent in particular.

3 Ofwat Tariff structure and charges 2004-05 report

There may be other analyses that we should consider, and would welcome any suggestions from stakeholders on this issue.

13.7 Impact of changes on customers

We are aware that Scottish Water currently offers two different caps on year-to-year changes in trade effluent charges:

- A harmonisation cap – where quality and quantity parameters remain the same, the year on year increase is limited to 15%. This has been used to offset the effects of harmonisation on some customers; and

- A treatment cap – customers in locations where treatment is being upgraded or provided for the first time will be subject to a 100% cap. That is, charges can at most double because of new treatment.

We will seek to understand the rationale for these caps and the impact that these caps are having both on other trade effluent customers and on the customer base as a whole. Again, subject to the requirements placed on us in the Ministers' statement on charges, we do not expect that it would be considered appropriate for domestic and non-domestic customers to pay more for foul sewage or for surface drainage as a result of these caps.

However, as *Paying for water services* explains, there may be a case for phasing changes in tariffs. We will make any changes in accordance with Ministers' requirements in this respect.

If any changes in trade effluent charges are to be phased, decisions would need to be made about who should meet the cost of this phasing (i.e. other trade effluent customers or customers as a whole). We would welcome views on this issue.

Section 2: Chapter 14
Business plans and the Strategic Review of Charges 2006-10

14.1 Introduction

This chapter explains the background to business planning in the Scottish water industry and describes the rationale, process and framework for business planning that we are putting in place.

Customers and other stakeholders are entitled to expect Scottish Water to have well-developed, sound and clear plans for the business going forward. We require a clear business plan to inform our Strategic Review of Charges.

The chapter begins by explaining what a business plan is and its aims. We outline the lessons to be learned from our request for business plans from the three authorities to inform the last Review. We then describe the role of business plans in the water industry in England and Wales and explain how we have drawn on experience south of the border to introduce a robust business planning format for Scottish Water.

We set out the timetable for the business planning process and a brief summary of the information that we expect Scottish Water to provide. We then describe the process we intend to follow to ensure that we have fully and correctly understood Scottish Water's business plan. Finally we outline how we intend to use the business plans.

14.2 The role of a business plan

A business plan is a company or organisation's statement of its strategy for the future. It should present clearly its forecast of revenue and costs. These forecasts should take account of the company's view on its customer base and the appropriate price of its services. It should provide clear evidence on costs. The business plan should also examine the challenges facing the company and assess the risks. The plan should set objectives and outputs. The company should also suggest how it intends to finance its investment.

A good business plan should reflect the circumstances of the business. The water industry is a long-term business. It has to look well into the future in order to ensure that this essential service will be available for future generations and at an affordable cost. It needs to plan to deal with long-term demographic, social, economic and other trends. Its assets – pipes, sewers, treatment work buildings, reservoirs, etc are long-term assets.

14.3 Scottish Water's business plan

In order to inform our analysis of revenue caps we have asked Scottish Water to provide us with a business plan. We hope that this plan will take a long-term view and will address all of the challenges the organisation faces. The business plan is Scottish Water's opportunity to set out its strategy.

The business plan is an important opportunity for Scottish Water to influence the outcome of the Strategic Review of Charges. The business plan has the following aims:

- To communicate Scottish Water's long-term strategic plans.
- To help us to calculate charge limits for 2006-10.
- To help us to set charge limits that will allow Scottish Water to carry out its core functions at the lowest reasonable cost to customers and whereby efficiencies and savings are passed to customers.
- To reassure us that there is effective stewardship of the assets.
- To reassure us that Scottish Water can maintain service to customers.
- To allow us to fund the agreed requirements of the Scottish Environment Protection Agency and the Drinking Water Quality Regulator.
- To allow us to fund any other requirements stipulated by Ministers.

The business plan is necessary to provide transparency. It also plays an important role in increasing the transparency of the Strategic Review of Charges. To this end we will require Scottish Water to publish its business plan. Stakeholders will be able to see what Scottish Water plans to do and what this might mean for bills. We would encourage stakeholders to comment on these proposals.

14.4 Background

The three former water authorities were required to produce annual corporate plans for the Scottish Office and later for the Scottish Executive. These plans had, to a limited extent, some of the features of a business plan, but were a good deal less comprehensive in scope. Since they were produced each year, they mainly concentrated on short-term objectives.

Until the introduction of the Quality and Standards process there was no coordinated approach to the assessment of the industry's investment needs. As a result, investment decisions were arrived at on a relatively ad hoc basis. The corporate plans included little detailed information about investment plans, and certainly not enough to have allowed any effective monitoring of value for money.

14.5 The Strategic Review of Charges 2002-06

When this Office was established at the end of 1999, it was clear that we would need to establish a clear framework for regulation. An important element of this framework was an annual regulatory return from the then three authorities. This Annual Return was to be consistent with Ofwat's June Return. We tendered an information project to assist us with the development of this framework. The information project deliverables were as follows:

- An Annual Return of data for regulatory purposes: this included cost allocations, performance measures, and customer information.
- An asset inventory: this included asset condition, performance, risk profile and replacement cost.
- A capital cost base: this included the major categories of investment and allowed comparison with benchmark performance.
- An investment plan: this included all investment projects required by the Quality and Standards process and ensured that a forward view of the asset inventory was possible.
- A strategic business plan: this was to inform us about how the authorities saw their environment. Our intention was that this should be analysed across five parameters: customers, competitors, costs, competencies and compliance.

The purpose of the strategic business plan was for each authority to set out the external influences on the business, the strategic policies being adopted and their impact on the authority. The strategic business plan for the *Strategic Review of Charges 2002-06* had two main sections:

1. The authority's view of its operating environment and a statement of the authority's strategy including:

- the macro-economic view of the region and the impact of changes in the economic factors on the customer base, the water and waste water services and other services provided;
- the impact of anticipated new legislation and options for change in the commercial structure of the water industry in Scotland;
- the impact of competition, the likely new entrants and their impact on the customer base;
- the scope and quality of the authorities' services
- customers' needs and the scope to extend services to customers.

2. A series of tables setting out a forecast of key indicators for the business including:

- population;
- volumetric projections of water delivered and waste water collected;

- financial summary of all costs, revenue and other sources of funds;
- financial assumptions such as inflation and interest rates;
- investment summary for water, waste water, support services and the Private Finance Initiative;
- income projections for water, waste water and other activities;
- proposed expenditure on the various drivers for the quality programme such as the Drinking Water Directive and the Bathing Water Directive;
- income and expenditure account projections;
- balance sheet projections.

The authorities were asked to provide this forecast information for the period up to 2010.

Unfortunately, the three authorities were unable to produce robust strategic business plans that could inform the *Strategic Review of Charges 2002-06*. There were particular problems in their ability to forecast changes to the customer base and the likely impact on their revenue.

It was also clear that their investment plans were inconsistent and needed to be more detailed.

The experience of having requested the authorities to provide strategic business plans for the *Strategic Review of Charges 2002-06* has influenced our approach to this Review:

- We have issued much more specific guidance to Scottish Water on what we expect from the business plan.
- We have provided detailed definitions for the forecast data that we want Scottish Water to provide.
- We have also tried to make the business plan relate more closely to the Annual Return where possible.

This last point is important because Scottish Water now has several years experience of providing us with Annual Return information. The authorities had no such experience before the *Strategic Review of Charges 2002-06*. Scottish Water also now has systems in place to collect and verify this information. The Reporter will check that Scottish Water is reporting consistent, robust information in its business plan.

We have also sought to require Scottish Water to define reasonable outputs of its planned investment programme. These outputs will help us to judge whether the proposals in the business plan will deliver value for money.

14.6 Role of business plans in England and Wales

Ofwat sets prices every five years. Water and sewerage companies submit a draft and second draft version of their business plan to Ofwat to inform Ofwat's price setting process. Ofwat defines the business plan as being the company's view of the price limits it needs and the reasons for them.

This view of the role of a business plan is useful, in that it requires companies to say what they believe prices to customers should be, and to set out the detailed components that lead to that assessment. This provides Ofwat with the transparency it needs in order to understand the issues and arguments made by companies. It also means that where Ofwat's view differs from a company's, it can calculate the projected impact of that difference of view on prices to customers.

These detailed business plans ensure that Ofwat and the companies are better able to focus any debate about the business plan on those items that are material to prices for customers.

In England and Wales, companies publish a summary version of their business plans. This introduces a degree of accountability to all stakeholders.

14.7 Introducing a business plan in Scotland

We have introduced a similar business plan requirement in Scotland. The *Strategic Review of Charges 2006-10* will therefore benefit from a similar level of transparency. We have adapted our requirements to the Scottish context. To do this, we have used external expertise from Scottish Water's Reporter team to help set out the requirements.

We are confident that the framework we are putting in place will provide us, the Scottish Executive and other stakeholders with a robust insight into Scottish Water's plans for the next several years.

14.8 The business plan process

Scottish Water will be required to submit a first draft business plan and a second draft business plan to us and to the Scottish Executive. The process for each of these submissions is essentially the same. The first draft business plan will enable us to do much of the preparatory work for the *Strategic Review of Charges 2006-10*. The second draft business plan will allow us to draw our conclusions on prices for the draft advice/determination of charges.

Opposite we set out a timetable showing the key dates relating to the business plan process. This timetable has been agreed between all stakeholders:

Date	Event
First draft business plan	
25/06/2004	WICS issue guidance on first draft business plan
05/07/2004	Scottish Water's initial issues to WICS
08/07/2004	Workshop on guidance
16/07/2004	Scottish Water's final issues to WICS
21/07/2004	Guidance to Reporter issued by WICS
28/07/2004	WICS' clarification of Scottish Water issues
01/09/2004	Draft investment plan to Reporter for audit
29/10/2004	Scottish Water submits first draft Business Plan to WICS
15/11/2004	Workshop on clarification of issues
23/11/2004	Scottish Water Board presentation on key strategic issues
03/12/2004	WICS' response to first draft business plan
Second draft Business Plan	
08/12/2004	Publication of guidance for second draft business plan
14/12/2004	Scottish Water's initial issues on guidance to WICS
17/12/2004	Workshop on second draft business plan guidance
17/12/2004	Guidance to Reporter issued by WICS
23/12/2004 10/01/2005	Scottish Water's final issues on guidance to WICS WICS final clarification/response to Scottish Water's Issues
31/01/2005	Final guidance from Ministers
20/04/2005	Scottish Water submits second draft business plan to WICS
04/05/2005	Workshop on detail of second draft business plan
12/05/2005	Scottish Water Board presentation on key strategic issues
16/05/2005	Publication of high-level summary of Scottish Water's business plan
30/05/2005	WICS' response to business plan and implications for customers

14.9 Business plan reporting requirements

The reporting requirements are split into three main components.

- Tables – into which Scottish Water must supply pre-defined information.
- Definitions – these relate to each row or information parameter within the business plan tables and specify what Scottish Water must provide.
- Guidance – which relates to the general principles to be followed when compiling the business plan submission. The guidance also indicates the information that Scottish Water must supply as part of its commentaries and supporting information, which accompany each section of the business plan.

14.9.1 Reporting requirement sections

The business plan is divided into three parts. These three parts are each important in informing our work on the Strategic Review of Charges. The three parts are:

Part A:	Overview
Part B:	Detailed supporting information
B1:	The business environment and the longer term
B2:	Improving efficiency
B3:	Maintaining service and serviceability
B4:	Quality enhancements
B5:	Supply/demand
B6:	Service delivery
B7:	Financial (including financial model inputs)
B8:	Populations and properties

Investment plan

A brief summary of each section is given below:

Part A: Overview

The overview provides a summary of the information contained in the business plan. As part of this summary, Scottish Water should put its strategic decisions for the forthcoming period. This should include supporting evidence and, critically, the key assumptions that underpin the strategy. Scottish Water should also explain how it intends to achieve these objectives.

Scottish Water may present this overview and supporting information in a format that it believes best demonstrates its objectives for the forthcoming period. The text should concentrate on:

- the outputs selected for Scottish Water's preferred strategy;
- an explanation of how Scottish Water will meet those outputs;
- the resources required to deliver the outputs allowing for improvements in efficiency; and
- the charges that Scottish Water considers its customers should pay.

Scottish Water should also explain how and why it believes its strategy reflects its customers' views on services and prices. This should be balanced with the views and requirements of other stakeholders in the industry such as the quality regulators and Scottish Ministers.

B1: The business environment and the longer term

Scottish Water should provide a detailed view of its future operating environment.

We expect this part of the submission to be divided into four sections. This structure provides a framework for Scottish Water to explain its assessment of the post 2006 environment in its own way.

The post 2006 environment:

- Section 1 - Achievements to date compared with earlier plans
- Section 2 - Assessment of the post 2006 environment for Scottish Water
- Section 3 - Managing the key risks and uncertainties
- Section 4- Achieving the right balance for customers

We do not require any additional information to support Scottish Water's explanations. However, Scottish Water may choose to provide references to information provided elsewhere in the plan.

B2: Improving efficiency

In developing its draft and second draft business plans, Scottish Water should decide on the scope for it to improve its efficiency by 2010. Scottish Water should provide detailed information about any factors that may adversely impact on its efficiency improvement.

As part of the business plan submission, Scottish Water should:

- set out its views on the scope for improvements in efficiency and the evidence on which they are based;

- explain how they lead to its assumptions about cost reductions from current levels that it has included in its strategy; and

- describe how the assumed improvements have been incorporated in the business plan expenditure projections.

Within its business plan, Scottish Water should state the effects of this efficiency on costs relating to all areas of the business and, importantly, how the efficiency savings can be passed on to customers.

B3: Maintaining service and serviceability to customers

This section of the business plan relates to how Scottish Water intends to maintain current levels of service to its customers and the environment by maintaining the serviceability of its assets (that is, the ability of the assets to continue to perform as they should).

The way in which Scottish Water determines what its capital maintenance requirement must be to deliver these levels of service should follow best or good practice established elsewhere. As part of the business plan, Scottish Water should provide examples of the methods it has used to establish the correct level of future capital maintenance.

A key component of Section B3 is that Scottish Water should state what impact the new or enhanced assets, needed to satisfy new quality obligations of *Quality & Standards III*, will have on the future capital maintenance requirement of the business. We would expect that all proposals should be the most cost-effective available and should offer the best value for money for customers. We will ask the Reporter to scrutinise a sample of the proposed solutions to ensure that Scottish Water's plans are cost-effective.

If the capital maintenance requirement for the period is materially different from that currently being undertaken, Scottish Water should also supply documentary evidence to support the change.

B4: Quality enhancements

We have asked Scottish Water to set out in Section B4 a detailed overview of its proposed quality enhancement programmes for the water and sewerage services. We expect detailed scheme-specific information to be provided in the accompanying draft investment programme submission. This must reconcile with the commentaries in this section and to the output of *Quality & Standards III* work packages.

Scottish Water must demonstrate that the impact of any new quality requirements as a whole has been considered, and that the chosen programme is the most appropriate whole-life solution for dealing with all of the quality obligations. The explanations should be at a strategic level in Section B4. Scottish Water should provide detail of the schemes in the accompanying draft investment plan.

Scottish Water should provide detail in the commentary explaining how it arrived at its proposed programme and how the requirements of *Quality & Standards III* work packages have been translated into schemes with discreet drivers and outputs.

B5: Supply/demand issues

The purpose of this section of the business plan is to provide information on the likely expenditure needed to maintain a balance between supply and demand in both the water and sewerage services.

There are two main reasons to seek additional expenditure for balancing supply and demand:

- To meet or manage growth in demand from customers (either existing or new).

- To restore the security of supply to customers in the light of improved information, for example, a downward revision in yields or contingencies related to possible climate change.

In Section B5, Scottish Water must provide details of the resource planning tools that have supported its analysis of supply and demand issues. These may include area resource plans, district meter area studies and drainage area studies. An important aspect of the supply/demand balance is an appraisal of leakage within the network. Scottish Water is therefore asked to provide details of its strategy to manage leakage to an economic and sustainable level.

It is critical to ensure that Scottish Water is using a suitably long-time horizon when analysing supply/demand issues. Good practice is for such analysis to be undertaken on a minimum ten- to fifteen-year horizon to ensure security of supply for future customers. The Reporter will be asked to pay particular attention to this, to ensure that Scottish Water is taking a suitable approach to managing its resources.

The business plan requires Scottish Water to identify both the capital and operational expenditure needed to fulfil the supply/demand need of the period. It is important that Scottish Water proportionally allocates costs correctly. Again, we will ask the Reporter to scrutinise the allocation of costs.

B6: Customer service strategy and service enhancements

This section of the business plan is Scottish Water's opportunity to state what it wants to deliver in terms of its levels of service to customers. This service should be split into two main categories:

- customer based – including such things as telephone response times and complaints procedures; and
- asset based – including such things as sewer flooding to properties and water pressure issues.

Scottish Water should use this part of the business plan to set out its strategy for delivering services to customers over the forthcoming period. It should indicate any improvements that it envisages providing for customers compared with the position it should achieve by March 2006. Such service improvements may be the result of investment in the quality programme or capital maintenance.

If Scottish Water seeks additional resources to improve levels of service from the *Strategic Review of Charges 2006-10*, it should provide a detailed summary of the outputs that will be delivered and their costs. Scottish Water should also demonstrate that this improvement is justified and that its customers are willing to pay. Scottish Water may also indicate any additional improvements it plans to fund if efficiencies beyond those assumed are achieved.

B7: Financial projections and financial model input sheets

In the first part of Section B7 Scottish Water should outline how it intends to finance the strategy set out in the business plan. It also requires Scottish Water to forecast strategic financial information and indicators for the forthcoming Review period.

It is particularly important that Scottish Water details all of the important assumptions that underpin its financing plan. In particular, we would expect to see forecasts relating to:

- the cost of debt,
- age of debt profiles,
- returns on capital,
- projected capital value,
- critical financial indicators.

Scottish Water should also explain how changes would impact on customers. In the second part of Section B7 we ask Scottish Water to provide the information required to establish the starting point for the financial model (a detailed description of the financial model will be published in a forthcoming volume of our methodology). It is critical therefore that all of the information that is submitted in these tables should reconcile and be consistent with the strategy and data contained in all other sections of the business plan.

B8: Properties and populations

In Section B8 of the business plan we ask Scottish Water to forecast what it believes its customer base will be over the forthcoming period. We are particularly interested in the assumptions that underpin these forecasts. Again, we will ask the Reporter to scrutinise these assumptions in detail. We would expect to see significant changes in the size and make-up of its customer base explained in some detail.

Information in this section breaks down the customer base into discreet sections. Examples of the type of splits that are made would include:

- domestic customers:
  - o metered,
  - o unmetered;
- non-domestic customers:
  - o metered
  - o unmetered
  - o large users
  - o those on 'special agreements'.

We also request information on Scottish Water's metering policies. We would expect Scottish Water to tell us about its overall metering strategy. Where appropriate, we would expect to see references to the detailed information supplied in the supply/demand balance tables of the business plan.

Investment plan

Scottish Water is required to submit information to support its planned investment programme. We collect this information in a spreadsheet format. The investment plan should be submitted with as much detail as possible. It should include drivers (what is driving the investment, for example a European Directive), outputs (what is being delivered by the investment) and the costs of each individual scheme wherever possible. We understand that Scottish Water will not have all of the necessary information for the first draft plan. Scottish Water should therefore provide as much detail as it has available.

The investment plan should take into account the ministerial guidance. This will outline the Minister's response to the consultation.

The investment plan is a major factor in the prices that customers will face. We will therefore use the Reporter quite extensively to ensure that the programme is properly defined and costed, is consistent with the ministerial guidance and contains no areas of overlap.

Once the Reporter completes his scrutiny of the investment programme, we will begin our work to assess the scope for capital efficiency.

14.9.2 Clarification of reporting requirements

It is expected that Scottish Water will raise issues concerning the reporting requirements of the business plan. Initially these issues will concern some of the underlying principles of the business plan. We welcome such challenges. Examples may relate to the timing of the submissions, degree of detail required at various stages, and the form in which information must be submitted.

We have agreed a process by which these issues can be discussed openly with Scottish Water. This is incorporated into the timetable shown earlier in this chapter.

Due to possible external challenge of the Strategic Review process, it is important that all issues are raised openly and resolved in a similar manner. This will ensure that there is a proper audit trail. This audit trail must withstand any external scrutiny that may be applied in the future.

14.9.3 The role of the Reporter

As we have indicated above, the Reporter and his team will play a significant role in the business plan process. It is his role to review, audit and verify the information submitted as part of the business plan. This follows regulatory precedent established in the industry in England and Wales, where the Reporter has proved invaluable in establishing a robust business plan process.

Once the reporting requirements have been established and provided to Scottish Water, we issue guidance to the Reporter. This gives details of the areas upon which we require him to concentrate his review of the information contained in Scottish Water's business plan. The guidance covers both the detailed audit of specific costs and information and the review of the soundness of Scottish Water's proposed strategy. After detailed discussion between the Reporter and us, a comprehensive audit plan will then be written by the Reporter, stating how he will undertake his duties and the specific areas that will be scrutinised. This audit plan will be shared and discussed with Scottish Water to enable an efficient audit process.

During the course of his duties, the Reporter should wherever possible scrutinise documentary evidence that supports the case being presented by Scottish Water. An opinion as to the soundness of this information is required to ensure that Scottish Water is taking decisions based on good quality information. Where necessary, the Reporter will also make site visits to discuss and verify information being used to support investment decisions.

The most important duty that the Reporter will carry out is to review and challenge the capital investment programme proposed. The Reporter and his team will, on a sample basis, audit and challenge the scope of requirements, proposed solutions and the basis of cost estimates for the proposed specific schemes. We will also ask the Reporter to comment on the overall size and scope of the programme. His comments should draw on his experience with other companies.

14.9.4 Clarification of the information submitted in the business plan

Once Scottish Water has submitted this detailed business plan, we will require an opportunity to clarify some of the information submitted. These clarifications are likely to range from high-level issues relating to the underlying strategy, to detailed queries on the information contained in individual tables. A process for clarifying these issues has been incorporated into the timetable shown previously in this chapter.

We have agreed that we will write to Scottish Water to raise any issues. These issues will then be addressed at joint workshops. In this way we hope that we can maintain an effective audit trail and keep the process as transparent and collaborative as possible. We are encouraged that Scottish Water agrees with this approach.

14.10 Scottish Water Board representation

The business plan process ends with a formal presentation of Scottish Water's strategy by its Board to this Office. We would expect this strategy to be consistent with the business plan and all of the information in the presentation to be consistent with the business plan tables.

There will be two such formal presentations – one for each business plan. Scottish Water will have a maximum of three hours to present its strategy and objectives. If we believe that there has been a material change in strategy between the first and second plans, we will seek to understand the reasons in some detail.

14.11 The strategic business plan 2006-10

Although the Strategic Review of Charges will only cover the period from 2006 to 2010, Scottish Water will have to pay attention to the longer term. Some of the work it plans and starts in the period will carry over beyond 2010. Capital investment will be in assets with lives well beyond 2010, and much of it over 50 years. Target dates for compliance with major environmental and drinking water quality standards lie beyond 2010 and Scottish Water will be working towards them.

At the highest level, Scottish Water's business plan will look at what it needs to do to meet the targets set for it. It will consider how the targets translate into outputs, that is, defined measurable results. It will set out the schemes that it believes will achieve the outputs. These schemes can be individual projects or a collection of projects to tackle particular issues.

Scottish Water must obviously consider how it can achieve the required outputs in the most efficient way possible. It must achieve a balance between capital expenditure, capital maintenance and operating expenditure. It will need to make decisions such as whether it is more efficient to meet an output by prolonging the life of an existing asset or developing a new replacement asset.

Scottish Water should also examine the most efficient way of financing the proposed work and its preferred balance between revenue and debt.

The cost of carrying out the work to achieve the output and the cost of financing the work will both ultimately influence the level of customers' bills. Scottish Water must therefore set out what its proposals will mean for customers.

14.12 Our review of Scottish Water's business plan

We expect Scottish Water to submit a draft business plan that contains a complete statement of its strategy. Our review will assess whether:

- the plan sets out a strategy consistent with the expectations on Scottish Water;
- the strategy has taken account of costs and benefits and considered possible risks;
- the plan shows a clear relationship between what is required of Scottish Water by legislation, guidance, stakeholders and its outputs;
- the outputs are clear, defined and measurable;
- the information is robust and is consistent with our guidance on the business plan.

We will work with Scottish Water to ensure that the business plan meets our needs and can be used to inform the price setting process. We will require Scottish Water to publish at least a summary version of the first draft business plan and both a summary and full version of the second draft business plan. The publication of this plan and, in particular, the detailed investment programme will be important in reassuring customers that they will receive value for money.

Section 2: Chapter 15
Appointment of a Reporter

15.1 Introduction

In previous chapters we have discussed our role in setting targets for Scottish Water and the importance for customers of monitoring performance against these targets. We have also described the importance of information in informing the regulatory process.

Successful regulation relies on high-quality information and analysis. Without it, the targets that are set for the regulated company may be too challenging or too easily achieved. This is not in the customer interest. If the targets are too challenging the company will not be incentivised to attempt to achieve the targets. If too easily achieved, customers are paying too much or receiving a poorer service than they should.

Poor information and analysis can also make the targets vulnerable to challenge. This impacts directly on customers and stakeholders, as it is the existence of clear targets that drives regulated companies to tackle inefficiencies, deliver investment and achieve customer service improvements.

In this chapter we discuss the improvements that have been made to information provision by the introduction of a regulatory Reporter for Scotland. We explain why we have introduced a Reporter into the water industry in Scotland and the benefits that it brings for customers. We compare the role of the Reporter in Scotland with that of the Reporters in England & Wales.

15.2 Improvements in information provision

In Chapter 4 we have described in detail the improvements in information gathering and performance monitoring that have taken place in recent years. Prior to the creation of the three former water authorities[1] in 1996, only very limited information was available about the performance of the water and waste water industry in Scotland. With the formation of the three authorities, the levels of available information, and hence the ability to monitor performance, gradually began to improve. However, there were initially still significant differences between the three authorities on the information they reported.

Shortly after the formation of this Office in November 1999, we signalled[2] our wish to undertake rigorous comparisons between the water authorities and between the industry in Scotland and in England and Wales. The subsequent 'information project'[3] led to the creation of a Scottish version of Ofwat's June return.

Our Office now holds Returns from 1999-2000 onwards for the three former authorities. Each of the three authorities submitted a Return for 2001-02. The Scottish Water transition team also submitted a consolidated return for the industry in Scotland. Since 2002-03, Scottish Water has submitted a single Return. From 2004 most of the tables from the Annual Return have been available on our website.

In recent years we have also introduced a range of other information gathering activities to augment our analysis capability and the robustness of the regulatory process. These include:

- Monthly financial returns. These financial reports, referred to as RAB Returns, provide a detailed breakdown of Scottish Water's financial performance over the preceding month and progress against annual budgets. This allows monthly monitoring of progress against the financial targets set out in the Strategic Review of Charges 2002-06;

- Quarterly returns on progress with the capital investment programme. These provide an update on progress, at a project level, with delivery of the capital investment programme. They contain information on: forecast and actual project spend, physical progress towards defined milestones, and explanations of financial variances;

- Quarterly Customer Service Performance Returns.

1 North of Scotland Water Authority, West of Scotland Water Authority and East of Scotland Water Authority.
2 In the interim Strategic Review of Charges published by the Water Industry Commissioner for Scotland in early 2000.
3 See Chapter 2, 'The collection and use of information'.

These provide information about Scottish Water's customer service performance and allow us to check compliance with guaranteed minimum standards of service; and

- Customer Revenue information. Scottish Water provides this information twice a year. The information covered in these returns includes detail of customer revenue, consumption and debt analysis. These Returns are invaluable in monitoring revenue on an ongoing basis. They ensure that Scottish Water's customer information is consistent with its declared revenues and with the revenue cap set by Ministers.

The development of these information returns has all contributed significantly to the quality of our analysis. The frequency and definition of these returns have strengthened the regulatory process. We now collect, process and analyse a large amount of information. We expect that the introduction of regulatory accounts will further improve the robustness of the regulatory regime.

We will continue to work with stakeholders to improve our information requirements. However, we believe that the benefits to customers from improved target setting and better performance monitoring are already being realised.

15.3 Quality of information

We believe that we receive sufficient information to support our analysis. Our focus is now on how best to improve the accuracy and reliability of that information.

We have been aware from our early work to establish the Annual Return that there were considerable issues with the completeness, accuracy and reliability of information about the industry. Even before we had finalised our full information requirements, we had asked the authorities for action plans to improve the quality of their management information.

Problems were encountered because of:

- multiple legacy systems;
- inconsistent definitions and references; and
- lack of systems or desire to maintain the currency of information.

In the period immediately before the *Strategic Review of Charges 2002-06*, we worked with the authorities to improve their understanding of key elements of information that we required to complete the Review. We organised a number of workshops and focused on those asset, cost and operating parameters that underpinned our efficiency targets. This process significantly increased our confidence in the key lists of information.

Following publication of the Review in November 2001, we began to address the issue of general information quality with the industry. This involved detailed scrutiny of the information received through the Annual Return and other information returns.

We analyse each return carefully. Our analysis looks both at the internal consistency of the information provided and the consistency of the information in the latest return with that provided in previous versions of the same (and other) returns. We also check any commentary from Scottish Water to see whether any differences are explained and, if so, to what extent.

We will then write to Scottish Water with any issues that we have identified and request clarification. Although this process is time-consuming, it does ensure that the quality of information improves considerably each year.

While we were pleased with the gradual improvement in the consistency and reliability of the regulatory information we received over the last two years, there was still significant room for improvement. In our *Costs and Performance Report 2001-02* we commented on the 2001-02 annual returns:[4]

> "It is clear that there needs to be further improvements, not only in the quality of information provided in regulatory submissions but also in the attention paid to the commentaries. In regulating the industry's performance, we rely on the commentaries to be complete and accurate.

[4] Costs and Performance Report 2001-02, published in February 2003, Chapter 3, Section 3.5, Page 18.

Unfortunately, in some instances significant changes in the information provided were not explained."

Issues with regard to the quality of regulatory submissions surfaced again during discussions about Scottish Water's business plan between March and May in 2003. The discussions on the business plan are described in detail in Chapter 5. Essentially, the issues centred on the validity of the targets set out in the Strategic Review of Charges and, in particular, the comparisons that were drawn with performance in England and Wales. Underlying the issues was a concern about the accuracy of the information on which the Strategic Review targets were based.

As described in detail in Chapter 5, the outcome of the business planning process was an agreement between the Scottish Executive, the Commissioner and Scottish Water on 'ten principles'.

Two of the ten principles relate to improving the quality of information submissions:

Principle 4

"A Reporter of regulatory information will be appointed as soon as practicable. The Reporter will operate in a fashion similar to Reporters in England and Wales. The Reporter should be appointed by the Commissioner and would be chosen from amongst persons that have served at least three years as an Ofwat-named Reporter. The Executive will meet the cost of the Reporter."

In England and Wales it is water industry practice for Ofwat to use a consultant engineer (known as a Reporter) to help verify a company's return. The Reporter audits the information provided to the regulator by the company and highlights any issues or inaccuracies. A detailed description of the role of the Reporter in England and Wales is provided below.

We appointed a Reporter for the water industry in Scotland December 2003.

The regulatory Reporter is Mr. David Arnell[5] of Black and Veatch Consulting. The Reporter's duties are covered in detail below but in summary we will ask him to review all aspects of Scottish Water's information returns. This will include the audit of both Scottish Water's annual regulatory return and its business plan. In particular, we will ask the Reporter to review the proposed investment programme to ensure that Scottish Water's investment plans are robust. Such scrutiny has played an important role in improving the quality and reliability of information provided to Ofwat by the companies in England and Wales.

Principle 10

"Scottish Water will engage with the Commissioner in improving the quality of data supplied to the Commissioner."

This principle recognised the requirement described above for further improvements in the quality of information supplied to us.

This principle has promoted joint thinking on how best to improve the quality of information provision. We believe that engaging with Scottish Water (and other stakeholders) to explain our analysis will lead to a more effective, transparent and robust regulatory regime. This will be in the interests of customers.

15.4 The benefits expected from appointing a Reporter for the Scottish water industry

There were four reasons why we were keen to appoint a Reporter:

- There was a need for an independent assessment of the quality and reliability of information provided by Scottish Water;
- We believed that a Reporter could assist in accelerating the improvement in information quality in Scotland;
- We believed that a Reporter could help Scottish Water ensure that proper processes for collecting,

[5] Mr Arnell is also the Reporter for Northumbrian Water Services Ltd.

storing and using information were established; and

- We believed that a Reporter could assist us in defining ‘core’ and ‘non-core’ activities and ensuring that the ‘retail’/’wholesale’ split was robust.

15.4.1 Reliability of information

Regulation can range from very simple analysis of information through to a highly technical exercise. An example of ‘simple’ regulation is the analysis of the number and type of payment options that are available to customers. This type of analysis might be carried out in order to assess the level of service received by customers and might involve a comparison with other utilities and water utilities in other jurisdictions. In contrast, there are other areas, such as the analysis of costs and efficiency, which require highly technical approaches. These approaches would include, for example, the use of statistical and econometric techniques for benchmarking costs.

These more technical analyses require better quality information in order to produce reliable conclusions. The Reporter can play an important role in ensuring that our analyses use the best information available.

Similarly, we are keen to understand the reliability of the answers generated by our analytical models. This is partly a function of the model, but the quality of the information used is also central to the reliability of the answer. The Reporter can help us to understand how the quality of information has affected our analysis.

15.4.2 Changes to the regulatory framework

Proposed changes to the regulatory framework contained within the Water Services etc (Scotland) Bill may have required the introduction of a Reporter for the water industry in Scotland. In his response to the Finance Committee, the Minister announced an intention to strengthen the regulatory framework significantly. These proposals involve the establishment of a Commission and the delegation of decision-making powers to that Commission. Scottish Water would gain a right of appeal to the UK Competition Commission.
The Scottish Executive is also proposing to require Scottish Water to establish a new non-core subsidiary that will become a licensed retailer. This licensed retailer would compete with new entrants after 2008 for the right to provide billing, collection and customer services to non-domestic customers. If both of these proposals are to be properly robust and able to withstand challenge, there would be a clear need for rigorous policing of the separation of activities within the water industry. Similarly, if the Commission is to be seen to act reasonably in reaching its decisions, it will have to be seen to have followed best practice. This will require both a very clear process and the use of independent expert scrutiny where appropriate. A Reporter is well placed to meet both of these needs.

15.4.3 The role of the Reporter in accelerating the improvement in the quality of information

A Reporter can help Scottish Water to improve the quality of its information. The Reporter can use experience from south of the border to help Scottish Water introduce best practice in the collection, storage and use of information. The Reporter will ask the following kinds of questions:

- What information is held by Scottish Water?
- How is the information produced?
- Which methods of information storage are used?
- What is the quality of the information that is held?
- What information is collected but not used?
- What use is made of the information?

When advocating improvements to be made by Scottish Water, the Reporter will benefit from being perceived as knowledgeable about best practice, particularly when drawing their experience of approaches successfully employed elsewhere.

15.4.4 Ensuring proper processes for information capture and provision

Good quality, reliable information can only be produced if there are effective processes in place for collecting information. The Reporter will have an important role in auditing the management of information and suggesting further improvements.

The Reporter brings a new level of independent scrutiny to the water industry in Scotland. This builds on the improvements in information provision that have already been made.

15.5 The situation in England and Wales

The concept of a regulatory Reporter was developed in the water industry in England and Wales. It is therefore useful to examine the function that the Reporter serves in England and Wales and to compare this with the current situation in Scotland.

In England and Wales, the *Reporters' Protocol* (Ofwat, March 2003) defines the framework within which the Reporters operate. The protocol sets out the following aspects of the framework:

1. the Reporter's role;
2. the reporting process;
3. Reporter and auditor relationships;
4. the scope and content of the Reporter's reports;
5. annual Reporter performance review arrangements;
6. external review of Reporter arrangements;
7. contractual aspects of Reporter and company relationships; and
8. the appointment procedure for Reporters.

Each of these elements is described in detail in the protocol. The provisions of the protocol are summarised below but the full text of the protocol is available in *Reporters to Ofwat*: Reporters Protocol from http://www.ofwat.gov.uk.

15.5.1 Auditors and Reporters

Each water company has a Reporter and an auditor. The role of the auditor is similar to, but more restricted than, that of the Reporter. The Auditor examines and evaluates his firm's financial and information systems, management procedures, and internal controls to ensure that records are accurate and that controls are adequate to protect against fraud and waste. They also review a company's compliance with corporate policies, laws and government regulations.

The Reporter will look in more depth at the company operations, its management information and the returns made to the regulator. Typically, the Reporter will rely on the auditor for a view on the accuracy of financial information.

15.5.2 The role of the Reporter in England and Wales

The role of the Reporter in England and Wales is to assist the regulator, Ofwat. The protocol specifies that Ofwat will have direct contact with the Reporter on any matters within the terms of reference of the appointment.

In carrying out its functions, the Reporter owes a primary duty of care to Ofwat, but also a duty of care to the company. It must, however, be completely independent of the company and avoid any conflict of interest by not accepting consultancy work from the company.

The Reporter is required to take account of comparative information published by Ofwat. He should also be fully up-to-date with the quality framework and guidelines established by the Environment Agency and by the Drinking Water Inspectorate.

15.5.3 The reporting process

The first step of the reporting process is for Ofwat to issue guidelines to the Reporter covering the scope of any audit and the issues to be addressed. In response to the guidelines, the Reporter submits to Ofwat a plan of the audit, outlining the method to be used and the detailed key issues that will be addressed. The company also receives a copy of the plan and has the opportunity to make representations to Ofwat. Ofwat will then agree the plan or require changes.

The Reporter must address the areas agreed in the audit plan. This is likely to involve commenting on material assumptions, including the consequences of their omission, reviewing the allocation of expenditure between categories specified by Ofwat, and checking in detail areas where expenditure is projected to be high.

15.5.4 Reporter and auditor relationships

The Reporter does not have to validate separately company information or systems if this duplicates earlier scrutiny by the auditors. Instead, he should acknowledge and report the auditor's scrutiny.

Reporters need to work with the auditors where there is overlap with regulatory accounts. Reporters should take advice on financial and accounting assumptions from the auditors in order to comment properly on the annual return.

Both Reporters and auditors must be mindful that the information in specific tables and submissions could be allocated to either the Reporter or the auditor. They should also note that audit arrangements must be sufficiently robust to withstand challenge on the grounds of weakness in scrutiny due to skill or experience gaps associated with scrutiny of engineering or financial information. These requirements encourage the Reporter and the auditor to take joint responsibility for scrutiny. The objective is to avoid a situation where both the Reporter and the auditor assume that the other has primary responsibility for the scrutiny of a particular piece of information.

15.5.5 The scope and content of the Reporter's reports

The protocol specifies that the Reporter's reports shall be free standing, ie the reader should be able to understand the report without direct reference to other documents. The protocol also specifies the points that should be addressed by the Reporter. These include:

- whether the company submission complies with Ofwat guidance;
- whether material assumptions have been exposed, challenged and assessed;
- the company's quantification of efficiency improvements in projections of operating costs and capital costs;
- an assessment of the quality assurance procedures used in relation to the production of the submission;
- a review of transfer prices;
- an assessment of expenditure on capital maintenance, quality enhancements and the compliance programmes, efficiency improvements, enhanced service levels, supply/demand balance, and leakage;
- an assessment of the extent to which the quality regulators have confirmed their agreement to the timing and phasing of the compliance programme outputs;
- an assessment of the reasons for changes to company policies and/or information submitted previously;
- an assessment of the methods and procedures adopted to produce the submission;
- an assessment of the company's evaluation of the ranges of uncertainty of cost estimates and output figures; and
- the response to any specific questions or areas of concern raised by Ofwat.

15.5.6 Annual Reporter performance review arrangements

Ofwat carries out an annual review of the Reporter's performance. These reviews are issued to ensure that each Reporter can take advantage of best practice. The review considers:

- the overall quality of the work carried out;
- the degree of assistance the reports give to Ofwat in its assessment of the company submissions;

- timeliness of the reports;
- how easy they are to understand;
- the completeness of both the company submissions and the Reporter's reports with respect to the reporting requirements and specific questions asked by Ofwat;
- evidence of the technical expertise that has been applied;
- the level of time commitment given to the work; and
- the costs incurred and how these compare with other such reviews and audits.

The Reporters are informed of the outcome of these reviews so that they can address any areas of concern and improve their performance in future.

15.5.7 External review of Reporter arrangements

Periodically, Ofwat appoints a review team to carry out an external review of the Reporter arrangements.

These reviews investigate:

- the consistency of individual Reporters' reports to Ofwat over time and between companies;
- the work carried out by Reporters and reporting teams in preparing their reports to Ofwat;
- the effectiveness of the arrangements for Reporters under this protocol; and
- other specific matters.

A team from KPMG and Babtie Group carried out the external review during the 1999 price review in England and Wales. The team stated:

> "The Reporters process is valuable to the Director in giving him an objective evaluation of the soundness and validity of the information employed by the water companies in the development and presentation of their Business Plans. The Director should feel confident in relying upon this evaluation."

15.5.8 Contractual aspects of Reporter and company relationships

The Reporter's contract is with the company and covers a maximum of five years. The company is responsible for paying all of the costs of the work carried out by the Reporter.

The company must allow the Reporter unhindered and timely access to its assets, systems, information, working papers, other records and relevant personnel. The company must make facilities available to allow the Reporter to inspect and copy materials, to inspect assets, and to use people and equipment to prepare a report.

15.5.9 The appointment procedure for Reporters

The company announces a competitive tender for a Reporter. Following the tender process, the company establishes a shortlist of a minimum of three Reporters. It then submits the shortlist to Ofwat, including:

- a recommendation as to the most appropriate Reporter to appoint;
- a tender evaluation report covering all tenders received by the company;
- details of the shortlisted Reporters and their teams, including relevant experience and proposals for how each Reporter intended to carry out the role;
- a critical appraisal of the shortlist, explaining why the company considers that its recommended Reporter is best suited to provide Ofwat with the services required.

Ofwat reviews the company's tender report and recommendation and may interview candidate Reporters. When it is satisfied with a candidate, Ofwat will approve the appointment.

15.5.10 The Reporter's role, the reporting framework and the reporting process

Terms of reference specify the Reporter's role, the framework for the introduction of Reporters (covering for example, the Reporter contracts, their appointment, and the duty of care that they owe), and the reporting process. The arrangements in Scotland are drawn from, and mirror closely, those in England and Wales.

However, there are two key differences between the arrangements for the Reporter in Scotland and those in England and Wales, namely:

- the description of the reports to be produced, and
- responsibility for paying Reporters' fees.

The *Reporters' Protocol* in England & Wales does not define the specific reports that the Reporter is expected to produce. Reporters are required to provide a report of the audit of any water company information submission requested by Ofwat. The protocol also requires the Reporter to carry out supplementary or special investigations of particular aspects of the water company business as requested.

In Scotland we can also require a report on any information provided by Scottish Water. However, we have also highlighted those areas where we have particular concerns. Our aim is to provide more clarity on our expectations. The Reporter in Scotland is likely to know most of the areas where we will require reports. This is partly because we need to prioritise certain areas in information returns for scrutiny. As the overall quality of information improves, we will look to the Reporter to broaden the scope of detailed scrutiny.

In England and Wales the companies are responsible for meeting all of the costs incurred by the Reporters in carrying out their activities. In contrast, in Scotland we have responsibility for paying the Reporter's fees. The Scottish Executive provides a grant to this Office to meet the costs of this work. On the one hand this will tend to reinforce the independence of the Reporter from Scottish Water. On the other, this may reduce the incentive on Scottish Water to work efficiently with the Reporter, as they are not paying directly for his services.

We will seek to ensure that we establish clear processes and protocols for Scottish Water's interaction with the Reporter to minimise the opportunity for inefficiency.

15.6 Conclusions

Information is vital to effective economic and customer service regulation. Specifically, we need accurate and reliable information on which to base our decision making when we set efficiency targets for Scottish Water. We also need accurate information in order to be able to assess Scottish Water's actual performance in meeting the targets.

Improvements in the regulatory process in recent years, specifically the increased volume of information provision and depth of analysis, have highlighted the need for an increased focus on the quality of information returns.

The introduction of a Reporter in Scotland will improve the quality and reliability of information provided by Scottish Water. The Reporter can offer Scottish Water the benefit of his knowledge of best practice in England and Wales in all aspects of collecting, storing and using information.

Annex 1
The Legislative Framework

This annex sets out in full the key statutory provisions referred to chapter 1.1. The complete Acts are available from HMSO – see http://www.hmso.gov.uk.

Section 13 of the Water Industry Act 1999 states:

75A. - (1) The Commissioner shall, when required by the Secretary of State, advise him on the matters to be taken into, or left out of, account by the new water and sewerage authorities in fixing charges in charges schemes (within the meaning of section 76(1) of this Act).

(2) The advice-

(a) shall, as the Secretary of State requires, relate to authorities generally or to a particular authority,

(b) shall apply in relation to charges schemes made during such period as the Secretary of State may specify (in this section referred to as "the period of the advice").

(3) In preparing his advice the Commissioner shall have regard to-

(c) the economy, efficiency and effectiveness with which authorities are using their resources in exercising their functions,

(d) the likely cost to each authority, for the period of the advice, of exercising the functions mentioned in subsection (4) below,

(e) the likely borrowing capacity of each authority for the period of the advice,

(f) any guidance issued to authorities by the Secretary of State, and

(g) any directions issued under section 116 or 117 of this Act.

Section 33 of the Water Industry (Scotland) Act 2002 repeats the provisions of Section 13 of the 1999 Act, replacing references to the three authorities with references to Scottish Water:

(1) The Commissioner must, when required by the Scottish Ministers, advise them on the matters to be taken into, or left out of, account by Scottish Water in fixing charges in charges schemes.

(2) The advice is to apply in relation to charges schemes made during such period as the Scottish Ministers may specify (in this section referred to as "the period of the advice").

(3) In preparing his advice the Commissioner shall have regard to-

(a) the economy, efficiency and effectiveness with which Scottish Water is using its resources in exercising their functions,

(b) the likely cost to Scottish Water, for the period of the advice, of exercising the functions mentioned in subsection (4),

(c) the likely resources, other than income from charges for goods and services, available to Scottish Water for the period of the advice,

(d) any guidance issued to Scottish Water by Scottish Ministers, and

(e) any directions given under section 44 or 56.

Section 3 of the Water Industry (Scotland) Act 2002, states:

3 Functions of the Commissioner

(1) The Commissioner must investigate any complaint made to the Commissioner or a Customer Panel by a current, potential or former customer of Scottish Water as respects any of its core functions.

(2) A Customer Panel must refer to the Commissioner any such complaint which is made to it.

(3) The Commissioner need not investigate a complaint under subsection (1) if-

(a) the complainer has not pursued the complaint with Scottish Water, or

(b) it appears to the Commissioner that the complaint is vexatious or frivolous.

(4) The Commissioner may, on behalf of the complainer in a complaint investigated under subsection (1), make representations to Scottish Water about any matter-

(a) to which the complaint relates, or

(b) which appears to the Commissioner to be relevant to the subject matter of the complaint.

(5) Where the Commissioner investigates a complaint referred by a Customer Panel under subsection (2), or decides not to investigate such a complaint, the Commissioner must send to the Panel a report of the investigation or, as the case may be, a statement of the reasons for not investigating the complaint.

(6) The Commissioner is to advise the Scottish Ministers on any matter which appears to the Commissioner or to them to relate to-

(a) the standard of service provided by Scottish Water to its customers, or

(b) the manner in which it conducts its relations with its customers or potential or former customers, in the exercise of its core functions.

(7) The Commissioner has power to do anything which is calculated to facilitate, or is incidental or conducive to, the exercise of the Commissioner's functions.

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